

**Auditor Independence in Malaysia:  
The Perceptions of Loan Officers and Professional  
Investors**

By

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## **ABSTRACT**

The current study examined several issues regarding auditor independence from the perspective of an emerging market such as Malaysia. A spate of ‘mini-Enrons’ in 2007 and 2008 has raised questions of investor confidence in the financial system specifically the national stock market. These scandals involving listed companies have highlighted concerns of regulators and other interested parties relating to threats to auditor independence. Factors affecting the ability of auditors to remain independent include long audit tenure, financial dependence on a single audit client, non-audit services provided to audit clients, ex-auditor employment with an audit client and the existence of audit committees. It is therefore timely to examine the importance of auditor independence in the provision of reliable and credible financial information. The current study uses a questionnaire survey to examine users’ (bank loan officers and professional investors) perceptions of the impact of the various factors on auditor independence.

The results of the study revealed that Malaysian users of financial statements have serious concerns about the threats to auditor independence. The results also reveal that audit committees are perceived as the main safeguard for auditor independence. In general, both groups of respondents agreed that the current regulations for auditors, as set down by the Malaysian Institute of Accountants’ By-Laws, were sufficient to safeguard auditor independence. However, there are mechanisms that the financial statement users believed should be implemented that could provide greater protection for their investment. For example, the loan officers in this study seemed to prefer mandatory audit firm rotation to partner rotation. Further investigation indicated that differences existed in perceptions across the examined demographic and background variables. The results of the study also suggest that Malaysian loan officers and professional investors still have faith in the auditing profession and this is reflected in their belief that audited financial statements are important for them to make lending and investing decisions.

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## **LIST OF ABBREVIATIONS**

ACCA	Association of Chartered Certified Accountants
ANOVA	Analysis of Variance
AOB	Audit Oversight Board
APB	Auditing Practices Board
BAFIA	Banking and Financial Institutions Act
BRC	Blue Ribbon Committee
CA	Chartered Accountants
CCCG	Combined Code of Corporate Governance
CCM	Companies Commission of Malaysia
CCP	Certified Credit Professional
CDRC	Corporate Debt Restructuring Committee
CEO	Chief Executive Officer
CFA	Certified Financial Analyst
CFP	Certified Financial Planner
CIMA	Chartered Institute of Management Accountants
CPA	Certified Public Accountants
CPE	Continuing Professional Education
FISDI	Financial Information System Design and Implementation
GAAP	Generally Accepted Accounting Principles
GAO	General Accounting Office
GC	Going Concern
GDP	Gross Domestic Product
IAASB	International Auditing and Assurance Standards Board
IAS	International Accounting Standards
ICAEW	Institute of Chartered Accountants in England and Wales
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
ISA	International Standards of Auditing

KLSE	Kuala Lumpur Stock Exchange
MACPA	Malaysian Association of Certified Public Accountants
MAS	Malaysian Accounting Standards
MASA	Malaysian Approved Standards on Auditing
MASB	Malaysian Accounting Standards Boards
MBA	Masters of Business Administration
MCCG	Malaysian Code of Corporate Governance
MIA	Malaysian Institute of Accountants
MICG	Malaysian Institute of Corporate Governance
MICPA	Malaysian Institute of Certified Public Accountants
MSA	Malaysian Standards on Auditing
NAS	Non-audit Services
NEAC	National Economic Action Council
NEP	New Economic Policy
NERP	National Economic Recovery Plan
PCAOB	Public Company Auditing Oversight Board
ROC	Registrar of Companies
RQ	Research Question
SC	Securities Commission
SEC	Securities and Exchange Commission
SOX	Sarbanes-Oxley Act
UK	United Kingdom
US	United States of America
WSRT	Wilcoxon Signed Rank Test

## CHAPTER 1 - INTRODUCTION

### 1.1 Introduction

Auditor independence lies at the heart of the auditing profession. Without unquestioned independence, audits are considered to have little value (Johnstone et al. 2001). Auditor independence is also important since it is one of the important elements of audit quality which contributes to the overall quality of financial reporting. The issue of auditor independence arises because of the significant roles that auditors play in attesting to the credibility of corporate financial statements. The auditors' roles are to provide an opinion on management's financial statements and assure stakeholders in organisations that the financial statements are a true and fair reflection of company performance. In order to perform these roles, it is crucial that auditors be independent of company management.

Research in the area of auditor independence is extensive since concern that auditors must be, and must be seen to be, independent of company management is not new. In recent years, it has become a major area of concern particularly when accounting firms have widened the scope of their services beyond their traditional audit services. The collapse of high-profile companies such as Enron, WorldCom and Waste Management in the US in the previous decade had been associated with the conflict of interests that arises when auditors provide non-audit services (NAS) to their audit clients (DeFond and Francis 2005). In the wake of the banking crisis in the UK, the House of Commons Treasury Committee (2009, p. 7) also commented;

*We note that the audit process failed to highlight developing problems in the banking sector, leading us to question how useful audit currently is. We also remain concerned about the issue of auditor independence and argue that investor confidence and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company.*

Independence in fact and independence in appearance are needed in establishing auditors' objectivity and integrity when verifying financial statements, particularly those to be filed with securities commissions (Olazabal and Almer 2001). The knowledge that auditors are actually unbiased when performing their duty is critical to the validity of an audit. In the case of unexpected corporate collapse, a failure in independence in appearance is enough to cause loss of confidence in audit and financial reporting (Fearnley and Beattie 2004). Houghton and Jubb (2003, p. 301) stated that "confidence in an auditor's independence is fragile since the appearance rather than fact of a compromise to this vital attribute is sufficient to violate it". When independence in fact is compromised, *prima facie* evidence of the lack of independence will further undermine confidence. A growing perception that there may be a real conflict of interests between auditors and their audit clients, if not addressed, could compromise the auditors' independence reputation that is the foundation of the profession. Thus, in the profession that depends so much on public trust, "a perception problem is real problem" (Sutton 1997, p. 90).

The importance of public perception of auditor independence is highly relevant in the case of Malaysia, a country that is not immune from accounting scandals. In fact, a spate of 'mini-Enrons' hit the country in 2007 and 2008, raising questions of investor confidence in the system and the local stock market (Zaimee 2007; Sidek 2008; Lee and Ali 2008). Even though there was no evidence against the auditors, the negative publicity connected to these scandals involving Malaysian listed companies was sufficient to damage the essence of the auditing profession i.e. public trust. If trust is betrayed, the profession too is destroyed as companies' accounts are perceived as untrustworthy and unreliable. In response to the recent financial scandals, the Malaysian regulatory and legislative authorities have implemented a number of reforms which include: regular updates on By-Laws or a code of ethics for professional accountants, the implementation of a practice review and a financial statement review by the Malaysian Institute of Accountants (MIA). The most recent reform was the establishment of the Malaysian Audit Oversight Board (AOB) in 2010, a body charged with the mission to oversee the auditors of public companies and protect investors' interests by promoting higher quality audit work.

## **1.2 Objectives of the study**

The main objective of this study is to provide an insight into the issues of auditor independence from the perspectives of an emerging market. The Malaysian audit market, while small in comparison to the UK and US audit markets, has experienced significant growth in recent years. Although several published studies have been conducted on the Malaysian audit market, these studies are dated (Gul and Yap 1984; Teoh and Lim 1996) and only focused on the general effect of a selection of factors on perceptions of auditor independence (Abu Bakar et al. 2005). Due to the recent outbreak of financial scandals involving Malaysian listed companies and the subsequent reforms in auditing and corporate governance practices, this study aims to provide further understanding and new evidence regarding the factors which potentially influence independence in the Malaysian context. Specifically, the study intends:

- 1) To investigate the impact of the following independent variables, namely: i) a lengthy relationship between audit firms and their audit clients, ii) audit firms' and audit partners' financial dependency on income from a single audit client, iii) the provision of NAS to audit clients, iv) former auditors' employment with audit clients, and v) the existence of an audit committee; on perceptions of auditor independence.
- 2) To analyse perceptions of those factors that may mitigate the problems surrounding auditor independence.
- 3) To examine whether the demographic characteristics of respondents in this study such as accounting qualifications, prior working experience as auditors or accountants in the industry, age, gender and type of respondents, affect their perceptions of whether the variables in (1) affect auditor independence.

This study is limited by the number of variables selected for investigation. The five variables were selected mainly due to two reasons: i) to keep the task manageable, and ii) compared to other independence issues, there is still no consensus in recent literature

regarding these five issues. Prior studies have also examined other factors affecting perceptions of auditor independence such as: i) the effect of gifts (Pany and Reckers 1980), ii) the purchased of discount arrangement (Pany and Reckers 1980), iii) the size of audit firm (Shockley 1981; Gul 1991; Beattie et al. 1999; Abu Bakar et al. 2005), iv) the clients' size (Pany and Reckers 1980), v) the nature of conflict issue (Knapp 1985), vi) the competition in audit services market (Shockley 1981; Knapp 1985; Gul 1991), vii) the client's financial condition (Knapp 1985; Gul 1989; Gul and Tsui 1992), viii) the practice of audit tendering (Gul and Tsui 1992), and ix) joint ventures with audit clients (Bartlett 1993).

In addition, this study only focuses on the practices of auditors of public listed companies. Since the practices of auditors of non-public companies, government organisations and agencies, cooperatives and societies are not subject to the same requirements imposed on the auditors of public listed companies examined here, the results and discussion in the current study may have little impact and significance on their practices.

### **1.3 Methodology**

The review of previous literature suggested a number of methods that could be used in this study. They include both qualitative and quantitative methods, for example, postal questionnaire surveys, structured and unstructured interviews and empirical experiments. After evaluating the strengths and weaknesses of each method and in recognition of cost and time constraints, it was decided that the postal questionnaire survey was the best method to be used. The current study also maintains a positivist position as the research objectives are achieved by conducting rigorous analysis and testing of the hypotheses based on the survey data.

To achieve the research objectives, this study explores loan officers' and professional investors' perceptions. Since they are among the main users of audited financial statements, their perceptions are important. It was argued that the ethical guidelines reflected the views and interests of the larger accounting firms and the committees'

subjective views of the perceptions of auditor independence of other users of financial statements (Firth 1980). The regulators cannot afford a biased position and must be continuously aware of the perceptions of those who depend on the profession's services (Shockley 1981). In addition, the perceptions of auditors are less relevant since they are the ones who prepare audit reports (Quick and Warming-Rasmussen 2005). Further discussion on the selection of respondents can be found in Chapter 5 (Research Methodology).

#### **1.4 Significance of the study**

As mentioned earlier, studies in the area of auditor independence are extensive and it may be that all potential factors likely to affect auditor independence have already been investigated. In spite these efforts, crucial issues remain unsolved in the research and literature. Subsequent to the collapse of Enron and the issuance of the Sarbanes-Oxley Act (SOX) 2002 in the US, research has placed most attention on the ongoing debate regarding the provision of NAS to audit clients and the potential these services pose to compromising auditors' objectivity and independence. The literature review, however, revealed little evidence to support the view that the magnitude of NAS fees causes auditors to become dependent on their client. DeFond and Francis (2005) argued that total fees paid to the auditor (economic dependence) would be a more relevant measure of the threat to auditor independence than the NAS fee components. Since this issue has also been overlooked in prior perceptual studies, it will be one of the focuses of the current research.

Moreover, prior literature has argued that different types of NAS affect auditor independence differently (Quick and Warming-Rasmussen 2005). It is the nature of a particular NAS that potentially impairs independence rather than NAS fees in general. Though this issue is important, very little research has been conducted in this area as it may have been overshadowed by the heavy emphasis on NAS fees. This study extends prior studies by examining this issue.

Research on the practice of ex-auditors seeking employment with audit clients is also growing. Recent archival studies indicated that ex-auditors' employment is negatively



affecting independence because ex-auditors may be less sceptical towards clients containing a high number of alumni (Menon and Williams 2004; Lennox 2005; Basioudis 2007). DeFond and Francis (2005) believed that this area will continue to be an important issue and that further research is desirable because of the effect this partiality may have on accounting firms. Since there is very little recent perceptual research on this issue, this study contributes to the body of knowledge and understanding regarding whether ex-auditors' employment with audit clients affects perceptions of auditor independence from the perspectives of financial statement users.

The literature review also revealed the importance of audit committees that are independent, active and have financial expertise. However, there is only one study, Sori et al. (2009), that has examined the impact of these characteristics on perceptions of auditor independence. In addition, no studies have been conducted on the impact on auditor independence (perceptual or archival) if audit committees have the authority to approve the purchase of NAS that are not specifically prohibited by SOX 2002 or the Code of Ethics of the International Federation of Accountants (IFAC). The implementation of these characteristics can be costly and financial statement users may have negative perceptions. This study further extends prior studies and contributes to the existing literature on auditor independence by investigating these issues.

The existence of the AOB in Malaysia also presents an opportunity for the current study to pursue. The AOB's establishment is an example of government intervention where the privilege of the accounting profession to self-regulate is removed and the authority to set, monitor and enforce the standards for accounting firms that audit public companies is brought under the responsibility of the board (DeFond and Francis 2005). Since governments tend to respond to public concern, they may intervene and impose new standards which may cause the profession to lose its privilege to self-regulate (Moizer 1991; Olazabal and Almer 2001; Firth 1980). Since this is a new area of research within the Malaysian auditing environment, it presents a gap for the current study to fill. This study examines respondents' perceptions as to whether the AOB should regulate the auditors of public listed companies in Malaysia.

Beattie et al. (1999) stated that reform of the regulatory framework for accounting and auditing and of the ethical guidelines is an ongoing process. The general setting within which auditor independence perceptions are formed is subject to continuous change. Consequently, policy-makers must constantly address new threats and seek new regulatory safeguards. The implementation of SOX 2002 in the US, frequent updates of the Code of Ethics by the IFAC and the issuance of Ethical Standards for Auditors by the Auditing Practices Board (APB) in the UK in 2004, reflect the regulators' concern over this matter and the current needs of the profession and the users of financial statements.

Despite the above regulatory initiatives, Dart (2011) argued that auditors' ability to perform their work with professional integrity remains questionable and highlighted the recent banking crisis in the UK as an example. It is noted that corporate scandals are always accompanied by scrutiny of the role of the auditors. Guenin-Paracini and Gendron (2010) argued that auditors are often (but not always) selected as a scapegoat in the wake of major corporate collapses, which is "largely reflective of sacrificial rituals" (p. 135). Hirshleifer's (2008) psychological bias theory of regulation offers a simple explanation regarding the intense period of re-regulation following Enron, that is the result of several underlying social processes and psychological biases which include scapegoating.<sup>1</sup> Scapegoating, which arises due to the urge to find someone to blame when things go wrong, creates support for regulation to prevent future misbehavior. Nevertheless, according to Humphrey et al. (2009), the typical questioning of the auditors in the aftermath of the recent banking crisis has been less prevalent than in the past. Humphrey et al. (2009) claimed that the auditing profession has actively responded to the financial crisis and clarified the specific role and obligation of the auditors in dealing with the crisis and debating the future developments of the auditing function.

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<sup>1</sup> Other elements of Hirshleifer's (2008) psychological bias theory of financial regulation include: salience and vividness effects, omission bias, xenophobia, fairness and reciprocity norms, overconfidence and mood effects.

In short, continuing studies in this area are still valuable because independence is fundamental to the audit process. With the frequent updates on the IFAC Code of Ethics, the current study may seem to have less meaning and impact. However, as the views of audited financial statement users (such as the loan officers and professional investors) in the development of such guidelines were not sought, it is uncertain whether such guidelines are sufficient to promote users' confidence in the independence of the auditors. It is hoped that the results of this study can provide a sound basis for Malaysian policy-makers to monitor auditors' activities, improve the current independence framework and help in promoting investor confidence in the local capital market. This study will be of direct benefit to the Malaysian auditing regulators particularly the MIA and the recently established AOB in updating and revising the current By-Laws on Code of Ethics as the perceptions of those actually rely on the financial reports can be considered in the latest revision of the guidelines.

## **1.5 Organisation of the Thesis**

The study is organised into eight chapters. Chapter 1 presents the background and objectives of the study, outlines its significance and briefly discusses the methodology used to achieve the research objectives.

Chapter 2 mainly examines the literature of auditor independence and focuses on the five independence issues selected, namely; long audit tenure, economic dependence, provision of NAS to audit clients, ex-auditors' employment with audit clients and the existence of an audit committee. Agency theory that provides a basis for the current research and prior models of auditor independence are also reviewed in this chapter. Issues are also discussed concerning safeguards against the threats to auditors, as is literature related to the background variables that have the potential to affect perceptions of independence.

Chapter 3 reviews the background of the auditing and financial reporting environment in Malaysia. This chapter describes the social and economic development of the country which involved the establishment of the accounting and auditing profession. The key

players in the profession and the roles they play in the financial reporting process are also highlighted.

Chapter 4 presents, in the light of the literature review, the research questions and its rationale. Based on the research questions, research hypotheses are developed and discussed in this chapter.

Chapter 5 attempts to elaborate in detail how the objectives of the study can be achieved. A discussion on the research methods and its justifications, questionnaire administration, data collection procedures and sample selection are outlined in this chapter. The chapter also describes the statistical methods used to analyse the data emerging from the postal questionnaire survey.

Chapter 6 presents the analyses of the survey data using the non-parametric and parametric testing. Based on the analyses, hypotheses are tested and the results are discussed.

Chapter 7 presents a summary of the research findings and provides comparisons with those of previous studies conducted in Malaysia and in other countries. The policy implications and contributions of the current findings are also highlighted in this chapter. Finally, Chapter 8 summarises the whole thesis and draws conclusions. This chapter also emphasises the limitations of the study and provides recommendations for future research.

## **1.6 Chapter Summary**

The main aim of this chapter is to provide a general overview of the present study. It discusses the major themes of the research, including the research objectives and research methodology. The sample selection and its rationale are also highlighted. This chapter also presents the significance and anticipated contributions of the study. The final part of the chapter outlines the organisation of the study and the content of each chapter.

The next chapter will present a review of the literature on auditor independence. Agency theory that underpins the current study and five factors affecting perceptions of auditor independence will be discussed. The literature on respondents' background variables that may influence perceptions will also be presented.

## **CHAPTER 2 - LITERATURE REVIEW**

### **2.1 Introduction**

The objective of this chapter is to present an overview of the literature concerning auditor independence. The position of the current study within the existing web of knowledge in this area can be determined from reviewing the literature since the study is based on previous research. This chapter will also assist in developing the research questions and research hypotheses which will further guide the current study and will be discussed in Chapter 4.

This chapter is divided into twelve sections. Section 2.2 provides definitions of auditor independence. Section 2.3 discusses agency theory that underpins the current study, while Section 2.4 reviews prior models relating to auditor independence which include economic models, behavioural models and auditor independence risk models. A discussion on auditors' moral development that may have an impact on their independence judgment is provided in Section 2.5. Section 2.6 reviews the literature of long audit tenure which has been the subject of debate as a factor that may threaten auditor independence. Next, the issues of fee dependence, NAS and ex-auditors' employment with audit clients are discussed through sequential sections. In section 2.10, the impact of the existence of an audit committee on auditor independence will be discussed. Section 2.11 discusses those demographic factors that may influence perceptions of auditor independence. Finally, the chapter ends with a summary and conclusion.

### **2.2 Definitions of Auditor Independence**

Auditor independence has been referred to as the cornerstone or the foundation of the auditing profession (Mautz and Sharaf 1961; Gramling and Karapanos 2008). Independence is traditionally regarded as being one of the fundamental principles underlying the auditor's work (Firth 1980). Pany and Reckers (1983) stated that the concept of auditor independence closely originated from the reason for the existence of

auditing itself, which is the need for reliable financial statements and which justifies the existence of the public accounting profession. However, over the years, practitioners and academics have struggled to find a definition for independence (Fearnley et al. 2005). DeAngelo (1981a, p. 116) defined independence as “the conditional probability that the auditor will report a discovered breach” and this has been claimed as the best known definition of independence (Fearnley et al. 2005) and has been cited in much prior research. Watts and Zimmerman (1983, p. 615) also stated “the probability that the auditors will report a discovered breach is effectively the auditing profession’s definition of independence”.

Gwilliam (1987) stated that independence is a concept that is difficult to define in absolute terms and that its meaning may change over time. McKinley et al. (1985, p. 892) and Pany and Reckers (1988, p. 35) further defined independence as the auditors’ “ability to act with integrity and objectivity”, while Knapp (1985, p. 203) described the term as “the auditors’ ability to resist client pressure”. DeFond et al. (2002) also suggested that auditor independence is synonymous with auditor objectivity and the ability to resist a client’s pressure to succumb to poor quality reporting. According to Bartlett (1993), the lack of clear definitions of independence in many previous studies has contributed to the inconsistencies in their results. Bartlett (1993, p. 55) defined independence as “an unbiased mental attitude in making decisions about audit work and financial reporting”. Bartlett (1993) believed that “bias” is a term that is widely understood by the general public and does not have a specific meaning common only to the accounting profession.

Indeed, auditor independence is associated with independence in fact and independence in appearance (Beattie et al. 1999; Craswell et al. 2002; Abu Bakar et al. 2005; Alleyne et al. 2006). Independence in fact is an unbiased mental attitude of the auditor, while independence in appearance (perceived independence) is the perception by a reasonable observer that the auditor has no relationship with an audit client that would suggest a conflict of interests (Beattie et al. 1999). It is difficult to measure independence in fact since it is unobservable (Beattie et al. 1999) and the fact that it is a frame of auditors’ minds makes it impossible to measure (Nieschwietz and Wolley 2009). Beattie and

Fearnley (2002) summarised various definitions of independence from the audit regulatory frameworks of Australia, the United States (US), Ontario, the Institute of Chartered Accountants in England and Wales (ICAEW), IFAC and the European Commission, concluding that the term ‘objectivity’ is generally easier to define than the term ‘independence’. Objectivity is a state of mind that is free of influences that can compromise auditors’ judgments and which has considered all factors relevant to the task, but no other. Beattie and Fearnley (2002) also noted a general consensus that the definitions of independence in appearance focus on what a reasonable and informed third party would believe. Thus, auditors must avoid those situations that would lead the third party to question their ability to act independently.

IFAC (2009, p. 37) defined independence in fact as “the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional scepticism”. Independence in appearance is “the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm’s or a member of the assurance team’s integrity, objectivity or professional scepticism had been compromised”. Given all these interpretations of auditor independence, our understanding of the concept is most important especially since regulators, academics and the public are more concerned about the impairment or lack of auditor independence that featured in the fall of Enron, other corporate collapses and high profile accounting scandals across the world.

The definitions of auditor independence provided in the above paragraphs aid in understanding the concept of auditor independence. In the following section, the theory that provides the basis for the current study will be discussed.



## 2.3 Agency Theory

Agency theory focuses on the relationship between principals (owners/ shareholders) and agents (managers). It is a theory that assumes there are principals appointing agents to perform certain services on their behalf, including delegating some degree of decision-making authority to the agents (Jensen and Meckling 1976). This relationship is articulated as a contract between the principals and the agents as its underlying mechanism, thus “the firm is seen as a nexus of contracts between principals and agents” (Shankman 1999, p. 321).

The foundation of agency theory is the assumption of self-interest of the principals and agents which diverge primarily because these different groups have different utility functions, desires and goals (Eisenhardt 1989; Hill and Jones 1992). This situation is also known as the agency problem and can lead to direct conflict over the use of resources (Hill and Jones 1992). Another essence of the agency problem is that it is difficult and expensive for the principals to verify what the agents are doing and whether the agents have behaved appropriately (Eisenhardt 1989)<sup>2</sup>. Subsequently, the principals will incur costs in establishing behavioural incentives and monitoring the actions of the agents (Culpan and Trussel 2005).

The appointment of an independent external auditor to verify the assertions made by the managers is an example of monitoring costs. The need for the verification of financial reports prepared by these managers arises since these financial reports are used to evaluate managers’ performance, which observation made directly by the principal would be costly. Due to an asymmetry of information and in the absence of verification, the managers have incentives to misrepresent the financial condition of the firm (Antle 1984; Arnold and de Lange 2004).

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<sup>2</sup> According to Arnold and de Lange (2004), where incomplete information and uncertainty exist, agency theory posits two agency problems: 1) adverse selection where the principal cannot ascertain whether the agents are performing the work for which they are paid; and 2) moral hazard - where the principal is not sure whether the agents have performed their work to their best ability.

According to agency theory, the main objective of conducting an external audit is to ensure that financial reports prepared by the management have been subjected to auditors' independent scrutiny (Arnold and de Lange 2004). The auditors' independence from the management is essential if they are to perform their roles satisfactorily. An audit is also intended to minimise agency costs since independent auditors can monitor the managers' behaviour and report more effectively and efficiently than can the principals themselves (Arnold and de Lange 2004).

Culpan and Trussel (2005) further emphasised that the primary aspect of agency theory is that the auditors must be independent of the company and its agents. This means that they must not have any conflicts of interest. Without that independence, the auditors would have no role to play within agency theory and their service would be of little or no value. For example, a conflict of interest may arise when auditors rely heavily on income provided to audit clients from NAS. Consequently, the capacity of the auditors to make arm's length judgments about financial disclosures may be undermined (Arnold and de Lange 2004). Culpan and Trussel (2005) cited an example of Arthur Andersen, Enron's external auditor which - at that time - also served as Enron's internal auditor as well as its financial advisors. Prior to the SOX 2002, CPA firms in the US were allowed to provide such NAS to their audit clients. Andersen received \$52 million in fees from Enron with slightly more than half of that amount for consulting services. Enron had also been the audit partner's only client for some years and was the main client of Andersen's local office. Both the partner and the office were economically dependent on income from Enron. In addition, it was also cited that a number of former Andersen's employees worked for Enron. These scenarios created a perception that Andersen's independence was impaired since there was at least an appearance of conflict of interests affecting the external auditor.

Agency theory has been criticised for being too narrow since the theory emphasises the contract between a principal and an agent and the ways in which the contract can be made more efficient only from the perspective of the principal (Wright et al. 2001). This economic theory is also too restrictive in term of human motivation as it assumes

individuals always seek to maximise self-interest. According to Kleinman and Palmon (2001) there are other factors that could affect human decision-making which include personal values, personality and the culture of the firms involved.

The following section reviews models relating to auditor independence, namely: economic, behavioural and auditor independence risk models.

## **2.4 Models of Auditor Independence**

According to Beattie and Fearnley (2002, p. 4), there are very limited analytical models concerning auditor independence since “no formal theory of auditor independence exists”. As a result, most studies attempting to design models of auditor independence “focused upon identifying the factors that potentially influence independence based on rational judgment”. In the following sub-section, economic models of auditor independence based on agency theory are discussed and their limitations analysed.

### **2.4.1 Economic Models**

Within the agency theory framework, DeAngelo (1981a) provides an economic modelling approach for analysing the auditor-client relationship and is widely cited, particularly in the research field of auditor independence (Geiger and Raghunandan 2002). She argued that the existence of client-specific quasi-rents to incumbent auditors would lead to a practice of setting audit fees below total costs or ‘low balling’ in the initial period of an audit engagement, thus lessening independence. The rationale for audit firms to practice ‘low balling’ is their ability to recover the loss incurred during the initial period by manipulating the client-specific quasi-rents that would accrue to them from continually auditing the same client. The client-specific quasi-rents arise from the existence of technological advantages on future audits of a given client and from the expensive transactions costs involved in changing auditors. Incumbent auditors can capture these rents by setting future audit fees above the total costs of producing the audits. However, if they realise that they stand to lose the quasi-rents, their independence may be compromised

as they attempt to retain the quasi-rents and to avoid termination of their contract by the client. Thus, DeAngelo concluded that low balling itself is not a threat to independence since the initial fee reductions are considered as sunk costs in the future and the rules prohibiting low balling will have little effect on the protection of independence.

In her subsequent study, DeAngelo (1981b) argued that larger audit firms have more audit clients and will be more independent than smaller audit firms because they have a greater risk of losing client-specific quasi-rents from other audit clients due to non-independent behaviour. Watts and Zimmerman (1986) supported these arguments, stating that large audit firms provide a larger bond for audits than smaller firms and thus have greater incentives to remain independent.

When statutory auditors provide NAS to their audit clients, the knowledge spill-over can flow from production of NAS to auditing, or auditing to NAS or in both directions (Simunic 1984). Simunic (1984) found that audit fees for companies that purchased management accounting services from their auditors were significantly higher than the audit fees of those that did not. Simunic interpreted this finding as consistent with the existence of efficiencies of joint production of auditing and NAS, concluding that audit demand is relatively elastic. Given the circumstances, the economic bond between the auditor and the client may be strengthened since the provision of NAS increases quasi-rents from audit services (Quick and Warming-Rasmussen 2005, 2009). In addition, the quasi-rents from auditing and NAS are higher than the quasi-rents from only auditing services (Quick and Warming-Rasmussen 2005, 2009). Therefore, auditor independence may become impaired due to the increased quasi-rents and increased financial dependence from the joint provision of audit and NAS. Houghton and Jubb (2003) added that the threat lies not only in the heightened fee dependence but also in the fact that the auditor may learn something about the audit client from the NAS activity but may be reluctant to report the issue during the audit as it may highlight weaknesses in the audit itself.

The problem with long audit tenure can also be explained from DeAngelo's (1981a) economic perspective. Geiger and Raghunandan (2002) argued that auditor independence

may be significantly affected in the earlier years of the auditor-client relationship if auditors are keeping their newly acquired clients long enough for the initial year's loss to be recovered through future quasi-rents. In the earlier years, the auditors may be influenced more by the new client management and the threats of dismissal are more effective against new auditors. Additionally, the auditors' reputation may be negatively affected if early termination is interpreted by the market as the auditors' problem and not the clients'. Thus, the threats of dismissal from the clients could adversely affect the auditors' professional judgment and the auditors may be more likely to issue an unmodified opinion as opposed to a going concern (GC) modified audit report for financially distressed companies.

Gwilliam (1987) criticised DeAngelo's (1981a, 1981b) economic model of the auditor-client relationship for failing to reflect "the full extent of the unequal relationship between management and auditor, a relationship which is customarily dominated by management by virtue of their control over the process by which auditors are appointed and dismissed" (pp. 103, 104). Similarly, Kleinman and Palmon (2001) were also concerned that DeAngelo's model does not involve the problem between the auditor and the client rather "the model speaks of 'the auditor'" (p. 19). This limitation is subsequently acknowledged by Antle (1984) in the following paragraph.

Similar to DeAngelo (1981a), Antle (1982, 1984) characterised auditors' independence behaviour as motivated by economic self-interest. Antle (1982) commented that prior theories of demand for auditing were incomplete since they ignored the problem of auditor incentives. He argued that modelling an auditor as an expected utility maximiser is similar to other models such as those that seek to understand the behaviour of owners, managers and investors. This allows the use of agency theory tools to examine the optimal contracting arrangements with the auditor.

The role of auditors is included in Antle's (1982) owner-manager model whereby the owners have a choice of whether to compensate the managers with a pure wage contract at the risk of minimal effort provided by the managers, to sell the right to receive the firm's cash flow to the managers or to hire auditors to verify the managers' financial reports.

Managers may report truthfully if their report is subject to auditors' verification. However, since audit services are not free, hiring auditors can introduce new incentive problems since the owners need to be concerned about the auditors' incentives. Antle illustrated that sufficient conditions for optimality of hiring auditors are more subtle than the 'quality' of information produced. The effects of risk-sharing were also considered in his model. He found that auditors prefer risk-sharing if they are sufficiently compensated for the risk borne.

According to Antle (1984), agency theory provides a natural basis in modelling auditing in a decision setting involving moral hazard (a setting in which the management has incentives to misrepresent the company's financial condition). In this setting, the owners hire auditors to produce information used in contracting the managers and thus the auditors are also the agents. As agents, the auditors are also assumed to behave as if they maximise expected utility while taking investigative acts and reporting under condition of moral hazard. Antle suggested that in such circumstances, there may be incentives for management and auditors to engage in co-operative behaviour or collusion (including side-payments). The auditors could reduce their audit efforts or decide to forgo their independence and accept side-payments from the management in exchange for not reporting truthfully. Antle claimed that the existence of lucrative income from management advisory services might act as a suitable disguise for such side-payments.

Antle's (1984) model suffers from several limitations. First, it is a single-period model and thus, it is difficult to extend to a multi-period situation (Kleinman and Palmon 2001). Second, it does not include any action incentivising auditors to maintain independence (Gwilliam 1987). Finally, Kleinman and Palmon (2001) commented that Antle's economic model that assumes individuals always seek to maximise utility is much too narrow, very similar to those made on DeAngelo's models concerning the issue of economic theories of human motivation.

### **2.4.2 Behavioural Models**

Behavioural models of auditor–client relationships take a more complex view of auditor–client interactions than do economic models. The power model, which will be discussed in the following paragraphs, examines auditors’ and clients’ resources to determine the likely outcome of any conflicts between them.

Goldman and Barlev (1974) argued that the threat to independence is built into the structure of the auditing profession and that this situation pressures the auditors to constantly violate the professional standards. A structure of auditing in which the auditors are being appointed and paid for services by their audit clients creates a potential conflict of interests for those auditors. This conflict may limit the auditors’ ability to resist management pressures, indicating a power asymmetry in the relationship, one which results in independence problems.

The authors held that auditors gain power when they are able to solve non-routine problems. They viewed consulting-type services as non-routine services. Consequently, they considered providing these services will increase the power and independence of the auditors. They argued that since the non-routine services benefit the client firm directly, preventing the auditors from providing such services “may result in a loss of valuable advice to the firm” and that this “is not likely to increase independence” (p. 715). In contrast, they held that the statutory audit is a routine service and exists primarily for the benefit of a third party. Given that the statutory audit involves many standardised procedures and requires minimal discretionary judgments, it is classified as a ‘low power relationship’ in the Goldman and Barlev model. This means that auditors are likely to be less independent if they only provide external audit services to audit clients.

From their power-based model of independence, Goldman and Barlev suggested three possible solutions to the auditor independence problem:

1. Decrease the potential power of management over the auditor by limiting its freedom of action,

2. Reduce auditors' flexibility of action, and
3. Change the structure of the auditing role.

The other behavioural model is established by Nichols and Price (1976) who developed their model based on Emmerson's (1962, cited in Nichols and Price 1976) theory of power and dependence and on Tibaut and Kelly's (1957, cited in Nichols and Price 1976) theory of exchange. Nichols and Price (1976) argued that the power asymmetry highlighted in Goldman and Barlev model is not caused by the audit function becoming a routine activity, and that a third party is the primary beneficiary of the auditor's services. Nichols and Price contended that, in a conflict situation, auditors' expertise and special skills may have little significance to the audit clients. In contrast, in exchange for their audit services, auditors highly value the fees offered by their clients. Since they place greater value on the rewards from the clients than the clients value their audit work, an asymmetrical dependency exists.

Nichols and Price's (1976) perspective on auditors' attitude to audit services is quite the opposite of that of Goldman and Barlev (1974). They argued that the fewer the number of discretionary judgments available to auditors, the less possibility of violations of accounting and auditing standards. Moreover, given that audit services involve a more routine task, detection of accounting violations is more feasible and promotes a stronger position of auditor independence.

Addressing the issue of management services and auditor independence, Nichols and Price claimed that there is not enough evidence to support or reject Goldman and Barlev's findings. They agreed with Goldman and Barlev's argument that in some situations, the provision of management services did increase the auditor's power to resist clients' pressures and would result in a higher dependency of the clients on the auditors.



### **2.4.3 Auditor Independence Risk Models**

In recent years, a number of studies have attempted to develop a broadly-based model of auditor independence that incorporates economic, regulatory, behavioural and ethical variables to explain auditors' decisions. Johnstone et al. (2001) presented a broad framework for considering independence risk. They defined independence risk "as the risk that an auditor's independence may be compromised or may be perceived to be compromised" (p. 1). Their framework identified various factors that may increase independence risk and categorises these as direct and indirect incentives. Examples of direct incentives included investments in the client's securities, significant financial dependence on the client and potential employment with the client. Indirect incentives included personal or family relationships with the client and auditing an auditor's own work because of preparing the client's financial statements or providing internal audit services. In this framework, judgment-based decisions involving difficult accounting issues, materiality and audit conducts were also included as factors that may contribute to, or result in, increased independence risk. Johnstone et al. (2001) also identified various factors that may mitigate the independence risk such as corporate governance mechanisms, audit firm policies, regulatory oversights, audit firm culture and an individual auditor's characteristics. Turner et al. (2002), however, criticised that the framework proposed by Johnstone et al. (2001) is loosely connected and that no attempt is made to formally relate the connections between the various factors.

Subsequently, Turner et al. (2002) presented a formal model of independence risk that considered various types of incentive, opportunity and lack of auditor integrity as variables that may affect independence risk and the respective safeguards to independence risk such as professional standards and auditors' characteristics. According to the authors, an opportunity is necessary to exist for the auditor to become sufficiently biased to make a significant impact on the auditor's report. Without opportunity, even though an auditor is lured with incentives, he or she may not compromise independence. Furthermore, it may be difficult for the auditor to become biased since there are already safeguards to independence risk due to incentives. The analyses showed that independence risk is

sensitive to each of the variables included in the model. The main results indicated that auditors' integrity is the key variable in minimizing independence risk.

Srivastava et al. (2009) extended the findings of Turner et al. (2002) by taking a threats-safeguards approach such as that included in the IFAC framework<sup>3</sup> and by providing two analytical formulas for independence risk for both the threats and safeguards situations. They argued that prior models did not explicitly consider the possibility of interactions or interrelationships among the key variables. These interrelationships (i.e. between incentive and opportunity) allow assessment about any threat to disseminate to each of the other threats, without actual evidence about the other threat (i.e. lack of integrity) being necessary. They assessed independence risk from two important viewpoints: the first demonstrating the existence of a possible expectation gap between external risk assessments made by a naive observer and internal risk assessments made by the auditor; and the second showing how knowledge of additional external safeguards (i.e. changes in regulations) affected external observer's assessments. Their analytical models showed a substantial difference between assessments by the two parties and highlighted the importance of signalling of independence by auditors through greater disclosures of how independence is maintained. Their models also indicated that the implementation of stringent regulations may substantially reduce the probability of impaired independence.

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<sup>3</sup> The threats-safeguards framework for defining and assessing auditor independence adopted by the IFAC identified five categories of threats: i) self-interest threat – the threat that a financial or other interest will inappropriately influence an auditor's judgment, ii) self-review threat – the threat that an auditor will not appropriately evaluate the results of a previous judgment made by the auditor or another individual within the same audit firm, on which the auditor will rely when forming a judgment as part of providing a current service, iii) advocacy threat – the threat that an auditor will promote a client's or employer's position to the point that the auditor's objectivity is compromised, iv) familiarity threat – the threat that due to a long or close relationship with a client, an auditor will be too sympathetic to the clients' interest, and iv) intimidation threat – the threat that an auditor will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the auditor. Safeguards that may eliminate threats or reduce them into an acceptable level fall into two broad categories: i) safeguards created by the profession, legislation or regulation, and ii) safeguards in the work environment.

## **2.5 Moral Development, Ethical Reasoning and Auditor Independence**

The psychology of moral development is a well-established field of research and theory. Moral psychology focuses on an individual's conception of ethical behaviour and how one's belief system dictates conflict resolution and problem solving in everyday living (Ponemon 1990). A number of researchers have looked at cognitive processes as a means of seeking a deeper understanding of auditor independence decision making using Kohlberg's (1969) cognitive moral development theory (e.g. Ponemon and Gabhart 1990; Windsor and Ashkanasy 1995; Tsui and Gul 1995; Sweeney and Roberts 1997). The theory posits that individuals are classified into three levels of moral development (each comprises two stages) according to a stage sequence model: pre-conventional, conventional and post-conventional levels. At the pre-conventional level, individuals make decisions to avoid penalty or to serve self-interests. At the conventional level, individuals become aware of the impact of their actions on others, thus conforming to the rules of society. Finally, at the post-conventional level, individuals form a judgment based on ethical principles which guide their behaviour.

Generally, the results in prior studies indicated that auditors with higher levels of moral development rely more on judgment and less on technical standards in making decisions. Ponemon and Gabhart (1990) found that auditors' moral development was significantly related to their independence judgments. In particular, they found that auditors with lower levels of moral development were more sensitive to penalty sanctions than auditors with higher levels of moral development. The results in Windsor and Ashkanasy (1995) indicated that when an auditor was confronted with strong economic pressure from client management during an audit conflict, the auditor's moral development may interact with personal beliefs in affecting independence. Tsui and Gul (1995) examined the interaction effects of locus of control, a personality variable and ethical reasoning on the behaviour of auditors in an audit conflict situation. They found that ethical reasoning, which was based on Kohlberg's (1969) cognitive moral development theory, moderated the relationship between locus of control and the auditors' responses to accede to client's request in an ethical dilemma situation. The results in Sweeney and Roberts (1997) were also consistent with prior results. They concluded that high moral reasoning auditors are unaffected by

client economic pressure and suggested that the independence behaviour of post-conventional auditors is motivated by concerns other than self-interest.

In the next sections, a review of previous studies on five factors that have the potential to affect auditor independence will be presented. They are: long audit tenure, fee dependence, NAS, ex-auditors' employment with audit clients and the audit committee. As mentioned in the previous chapter, the literature is still debating whether these five factors affect auditors' ability to remain independent. The first factor reviewed is long audit tenure and its impact on auditor independence is presented in the following section.

## **2.6 Long Audit Tenure**

The proponents of mandatory auditor rotation have argued that long auditor-client relationships may lead to an economic bond forming between the auditors' and the clients' firms, one that could result in familiarity and personal connection between them (Gul et al. 2007). The concern is that, over time, the auditors may become too close to the clients and lose their "honest disinterestedness" (Mautz and Sharaf 1961, p. 208). Furthermore, as the audit tenure increases, there is a tendency for the auditors to gradually align their decisions with the wishes of management, thus compromising their independence (Geiger and Raghunandan 2002; Jackson et al. 2008). In addition, after serving audit clients for a long time, a continuing relationship may affect the auditors' ability to remain objective and time further reduces their ability to make a critical appraisal (Carey and Simnett 2006). All of the above arguments support Shockley (1982), who claimed that long auditor-client relationship could have the following effects: complacency, lack of innovation, less rigorous audit procedures and a learned confidence in the client.

In order to overcome the above problems, mandatory rotation of audit firms has been suggested as an effective means of enhancing auditor independence and would enable auditors to exercise greater objectivity (Wolf et al. 1999). The idea is that, when audit tenure and related revenues are limited to a specified term, auditors will have less incentive to seek future economic gain from a specific client and will be less likely to submit reports

in favour of that client (Comunale and Sexton 2005). In addition, advocates of mandatory audit firm rotation also claimed that a new auditor would bring greater scepticism and a fresh perspective that may be lacking in long-standing auditor-client relationships (Nagy 2005; Vanstraelen 2000).

However, the opponents of mandatory auditor rotation suggested that the threat to auditor independence may be greatest during the first few years of an auditor-client relationship due to a lack of client-specific knowledge such as unfamiliarity with a client's accounting system or a firm characteristics (Gul et al. 2007; Morrill 2008). In addition, the accounting profession is questioning whether the likely benefits of rotating audit firms can outweigh the increased costs for the audit firm, the client and the public. Arrunada and Paz Ares (1997) claimed that mandatory audit firm rotation makes audits more costly due to increments in production costs and a decrease in competition in the audit market. The cost increments are associated with the damage of a substantial amount of specific assets and the need to rebuild in each rotation. Gates et al. (2007) also supported these arguments, stating that large 'start-up' costs relating to the audit lead to a situation in which audit firm rotation may be both costly and risky, in that errors may be undetected. From another perspective, Fearnley and Beattie (2002) claimed that regular rotation of audit firms and companies would add costs to both parties, both as management time for the companies and as learning time for the auditors.

Recognising these conflicting views as to auditor tenure, the General Accounting Office (GAO) (GAO 2003) in the US conducted a survey on the largest public accounting firms and the Fortune 100 publicly traded companies they audited, finding that the majority of respondents considered the cost of rotating auditors to exceed its benefits. Instead, a large majority of respondents believed that partner rotation, as required by the SOX 2002, would be sufficient to overcome the problem of long audit tenure. Thus, GAO (2003) concluded that mandatory audit firm rotation may not be the most efficient way to improve auditor independence and called for additional research on the topic. Following Section 203 of the SOX 2002, the SEC issued its rules on audit partner rotation in 2003 which required

mandatory audit partner rotation every five years with a five-year 'time out' period to increase audit quality (SEC 2003).

The IFAC (2009) also recognised that prolonged use of the same engagement partner on an assurance engagement would create a familiarity threat. The IFAC Code currently requires that the engagement partner be rotated at least every seven years and should not participate in the audit engagement until two years have elapsed (IFAC 2009). In the UK however, the revised Auditing Practices Board's (APB) Ethical Standard required engagement audit partners to be rotated every five years with a five-year time out period (APB 2009). The ICAEW responded that the APB should be consistent with the IFAC with regard to rotation rules since there have been many changes to the regulations in the post-Enron period (ICAEW 2009). Therefore, the ICAEW suggested that the APB should adopt a seven-year rotation period instead of five, since there is no evidence to support the suggestion that auditor independence is actually enhanced by rotating audit partners every five years. At present, countries that have adopted a mandatory rotation policy (firm or partner) include; Austria, Australia, Brazil, Greece, India, Italy, Israel, Singapore, South Korea, Taiwan, the Netherlands, Germany, Japan, Malaysia, the UK and the US (Fargher et al. 2008; Carey and Simnett 2006; Chen et al. 2008).

Research in the area of long audit tenure has been examined from two major perspectives; a behavioural approach and the archival approach. The behavioural approach focuses on auditors' and third parties' judgments and perceptions regarding the impact of such a factor on the appearance of auditor independence. The archival approach, however, attempts to provide evidence of factual impairment of auditor independence (Sharma and Sidhu 2001) and permits a more objective investigation into the effect on auditor independence of a long auditor-client relationship. The present study is concerned with third parties' perceptions of auditor independence. Nevertheless, reviewing archival research in this study is very important in order to develop a better understanding of the issues under study. The following sub-sections review the two perspectives.

### **2.6.1 Studies using the Behavioural Approach**

Long-term audit tenure has been identified in prior studies as one of the factors that may affect perceptions of auditor independence (e.g. Firth 1980, 1981; Beattie et al. 1999; Kaplan and Mauldin 2008). The early research, however, reported a lack of concern over the potential impact on auditor independence of a long auditor-client relationship. Firth (1980) investigated the role and importance of auditor independence as perceived by preparers and users of financial statements. Questionnaires postulating 29 auditor-client relationships were sent to the respondents and they were asked whether they thought each of the relationships would impair a firm's investment and lending decisions. Firth (1980, p. 465) found that a large majority of respondents in his UK study perceived auditors to be independent when the following statement was asked; "an audit partner has been in sole charge of a large audit (taking up to three months of the partner's time) for the past ten years". In his subsequent study that focused solely on bankers' perceptions, Firth (1981) concluded that this apparent lack of concern over a long-period relationship between auditor-client might be due to the perceived increase in expertise of the audit partners outweighing the potential impairment of independence.

In the US, Shockley (1981) examined the perceptions of audit partners, financial analysts and loan officers and also found that the effect of audit tenure on auditor independence was not significant. Using an experimental design approach, Shockley studied the impact of two types of audit tenure; five years or less and more than five years, on the possibility of impairing auditor independence

These studies (Firth 1980, 1981; Shockley 1981) however are dated and current perceptions among respondents may have changed dramatically particularly following the recent incidents of corporate failures. In addition, the findings in Firth (1980, 1981) could not be generalised to encompass the current situation, particularly when countries such as the US, UK and Malaysia have adopted a five-year rotation period, since these studies used a ten-year period as a measure of long audit tenure.

A Malaysian study by Teoh and Lim (1996) provided early evidence that respondents perceived auditor independence as negatively affected when auditors continued to serve audit clients for a period of more than five years. The study employed an experimental research design and the research instruments were issued to 100 chartered accountants (CAs) and 100 accountants from the industry. A recent Malaysian study, Abu Bakar et al. (2005) used a questionnaire survey in examining loan officers' perceptions of several potential factors, including audit tenure, that may influence auditor independence. Their results supported Teoh and Lim (1996). However, Abu Bakar et al. only examined the impact of audit tenure on independence in general, failing to specify the number of years of audit tenure that may result in auditor independence impairment. The study also failed to examine whether the Malaysian bankers perceived auditor rotation (firm or partner) as a factor that can mitigate the problem of compromised independence.

In the UK, Beattie et al. (1999) used a questionnaire instrument that consisted of a large set of 45 economic and regulatory factors that may impair or enhance auditor independence. They found that rotation of audit partners at least every seven years was ranked highly by their respondents (who consisted of audit partners, finance directors and financial journalists) as one of the factors that may enhance auditor independence. Beattie et al. however, did not question whether the respondents perceived that a long auditor-client relationship would have an impact on auditor independence. This question is important since respondents might perceive long audit tenure as non-threatening. The question of whether audit partner rotation leads to auditor independence enhancement might therefore not matter. Nevertheless, while most prior studies only focused on factors threatening independence, Beattie et al. (1999) also examined independence-enhancing factors, those factors which may be capable of affecting respondents' perceptions positively.

Alleyne et al. (2006) and Al-Ajmi and Saudagaran (2011) replicated the work of Beattie et al. (1999) and included a lengthy tenure of over 10 years as one of the factors that might lead to independence impairment, the issue not explicitly explored in Beattie et al. (1999). The results showed that the lengthy audit tenure was ranked moderately high (ranked 10<sup>th</sup> out of 23 factors undermining independence) by audit partners in Barbados. They



suggested that lengthy tenure may have been desirable to most auditors in Barbados since it allowed them to be more familiar with the clients' operations, thus reflecting the closeness of Barbadian society in general. On the other hand, Al-Ajmi and Saudagaran (2011) reported that long audit tenure was ranked highly by financial analysts (2<sup>nd</sup> out of 22 factors undermining independence) and moderately high (8<sup>th</sup> and 16<sup>th</sup>) by auditors and loan officers. Just as with Firth (1980, 1981), the use of the 10-year period in Alleyne et al. (2006) Al-Ajmi and Saudagaran (2011) is too lengthy to measure long audit tenure, making it difficult to generalise the findings in the current situation.

The results in Gates et al. (2007) revealed that MBA students and law students in the US showed a greater confidence in the financial statements of companies among which audit firm rotation is being exercised as compared to when there was only audit partner rotation or when no rotation was exercised. The study also revealed that in spite of strong corporate governance, the rotation of audit partners did not change the respondents' level of confidence in the reported earnings. The findings in Gates et al. (2007) suggested that, contrary to the GAO's (2003) assumption and to SOX's rules on audit partner rotation, audit firm rotation will better improve audit quality and enhance auditor independence. However, the results of this study may be affected by the choice of respondents (MBA students and third year law students) with an average age of 28 years (in both groups) who might have limited knowledge and experience on the issue under scrutiny. The findings perhaps reflected the concerns of inexperienced users of financial statements who will normally be more negative with respect to whether or not an audit firm should be rotated after a specified period.

The findings in Kaplan and Mauldin (2008), however, failed to support Gates et al. (2007). This study utilised an experimental approach, hypothesising that if audit firm rotation strengthens auditor independence in appearance, then non-professional investors will perceive higher auditor independence and expect lower reported earnings. The treatment variables in this study included audit partner and firm rotation. They also included the audit committee strength treatment which was graded as either strong or weak. The results of the first experiment, where the rotation policy is every 5-year, showed that across the

two levels of audit committee strength, the non-professional investors' perceptions did not significantly differ between the two audit rotation policies. Similar results were also found in their second experiments where the rotation policy was for rotation every 25 years.

Similar to Gates et al. (2007), Kaplan and Mauldin (2008) used MBA students as proxies for non-professional investors. Thus, the sample is not representative of more sophisticated users such as institutional investors and financial analysts.

In a recent US study, Daniels and Booker (2009) conducted an exploratory analysis that focused on bank loan officers' perceptions of mandatory audit firm rotation. A questionnaire containing 10 statements about general perceptions of mandatory audit firm rotation, independence and audit quality was sent to 1000 loan officers throughout the US. With a 21% response rate, Daniels and Booker found that majority of respondents (53%) supported mandatory rotation of audit firms and perceived that the rotation will increase auditor independence. The results also revealed that a substantial proportion of the respondents (46%) disagree that the rotation of audit partners would effectively achieve the same intended benefits as mandatory audit firm rotation. The results of the study supported Gates et al. (2007). Though the study only considered perceptions of bank loan officers, the author concluded that public listed companies should consider voluntarily adopting an auditor rotation policy as it appeared to enhance perceptions of independence.

In a recent UK study, Dart (2011) examined investors' perceptions of long audit tenure using a questionnaire survey. 113 and 254 usable responses were received from institutional investors and private investors, indicating 16% and 28% response rates respectively. The results of the study were similar to those recorded in Firth (1980; 1981) that the majority of UK investors disagreed that long-term audit tenure is a threat to auditor independence. The results also suggested that private investors were more concerned about long audit tenure than were institutional investors. Moreover, the study showed that both groups of investors seemed satisfied with the current regulations concerning partner rotation. Nevertheless, it was also revealed that the private investors were proponents of mandatory audit firm rotation as a means of greater protection of investments.

The results in the most recent study by Beattie et al. (2013) seemed to support the findings in Dart (2011) as they found that the rotation periods: i) every five years for audit partners and independent review partners, and ii) every seven years for other partners and other staff in senior positions, had no significant impact on audit quality in the post-SOX 2002 environment. The study examined the views of UK-listed company chief financial officers, audit committee chairs and audit partners on the impact of 36 economic and regulatory factors on audit quality using a questionnaire survey. The study concluded that the lack of any perceived impact on audit quality of a significant number of factors (including the new rotation rules), together with respondents' widespread concern that many aspects of the new regulations were "largely process and compliance driven (i.e. rules-based), with high costs for limited benefits" (p. 77)

Discussed in the following sub-section are the effects of lengthy auditor-client relationships on surrogates of auditor independence using archival data.

## **2.6.2 Studies using the Archival Approach**

Much of the recent literature on mandatory auditor rotation that used the archival approach employed absolute and signed abnormal accruals estimates using Jones' (1991) model as proxies for audit quality and independence impairment (Johnson et al. 2002; Myers et al. 2003; Jackson et al. 2008)<sup>4</sup>. These studies failed to provide support for mandatory auditor rotation, their evidence suggesting: that earnings quality did not change significantly over time (Jackson et al. 2008); that longer audit firm tenures were associated with lower extreme income increasing and extreme income decreasing accruals (Myers et al. 2003);

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<sup>4</sup> Abnormal accruals measure earnings management and thus measure the extent to which auditors constrain management's extreme income increasing or income decreasing accruals (Chi et al. 2005; Chen et al. 2008). Furthermore, discretionary accruals are accruals that do not relate to normal operating activities. Thus, a higher level of these accruals may indicate that management has been able to exert its power over the auditor by being able to report on terms favourable to the management (Jackson et al. 2008).

and that short auditor tenure was associated with lower earnings quality (Johnson et al. 2002).

Prior research on audit failures also documented evidence that mandatory auditor rotation does not improve audit quality (e.g. Geiger and Raghunandan 2002; Jackson et al. 2008 Shafie et al. 2004). These studies used auditors' failure to issue going-concern (GC) audit reports to companies prior to bankruptcy as proxy for audit failures. The findings from these studies supported the argument that the threat to auditor independence may be the greatest during the first few years of an auditor-client relationship. Most of these studies predicted that short audit tenure and financial reporting problems are due to a lack of client-specific knowledge and/or lack of auditor independence, owing to the auditor's incentive to maintain new client relationships. Only Carey and Simnett (2006) found evidence, from a sample of distressed Australian companies, that an auditor's propensity to issue a GC opinion diminished over the audit partner's tenure. Unlike prior studies that examined audit firms' tenure, Carey and Simnett (2006) examined audit partners' tenure and therefore the conflicting findings might be justified.

Carcello and Nagy (2004) argued that studying the impact of audit tenure on fraudulent financial reporting is more important since the regulators will be more proactive in viewing dramatic remedies if fraudulent financial reporting is found to increase with an increase in audit tenure. They investigated the relationship between audit tenure and a sample of US data, consisting of companies that have violated the US Securities Act through fraudulent financial reporting. They found a higher incidence of fraudulent financial reporting in the early years of the auditor-client relationship. No evidence, meanwhile, was found to support a higher incidence when tenure was long. The results suggested that audit quality is reduced in the early years of audit tenure and thus failed to support mandatory auditor rotation.

The literature surrounding the effects of tenure-length also extends to the issue of financial restatements. Stanley and DeZoort (2007) argued that financial restatements due to error or fraud are an indication of reporting failures. This is because when audited financial

statements are restated, the validity of an audit opinion and the underlying audit process are subject to question, owing to the previously released information containing material misstatements. Using matched samples of restatement and non-restatement companies in the US during the year 2000 through to 2004, they found that short audit tenure was negatively related to the likelihood of restatement. Similar to prior findings, they offered no support for mandatory auditor rotation.

While most of the prior literature focused on the impact of audit firm tenure on audit quality, a number of Australian studies examined the relationship between audit partner tenure and audit quality (e.g. Fargher et al. 2008, Carey and Simnett 2006). Unlike other jurisdictions such as the US, the Australian auditing standards and legislation require the audit report to be signed in both the audit firm's and the engagement partner's names which allows the identification of engagement partner tenure (Fargher et al. 2008).

Fargher et al. (2008) found some evidence for the claim that audit partner rotation brings 'fresh eyes' to the engagement. They found that accounting discretion decreased in the initial years of the audit tenure when the new partner was from the same audit firm as the outgoing partner. However, they found contradictory results when the new partner was from a *different* audit firm. Likewise, the findings in Hamilton et al. (2005) supported audit partner rotation because they found evidence that changes in audit partner were associated with lower signed unexpected accruals. However, a study by Carey and Simnett (2006) found no evidence of an association between long partner tenure and abnormal working capital accruals.

The results of a study in Taiwan also supported the earlier findings. Chen et al. (2008) exploited an institutional feature in Taiwan by examining the relationship between audit partner tenure and earnings quality during the period 1990 to 2001. The study found some evidence of increases in negative discretionary accruals as partner tenure increased. However, after controlling for audit partner tenure, the results showed that absolute discretionary accruals decreased significantly with audit firm tenure, providing further support for the rotation of audit partners.

Despite the findings in prior studies, Chi et al. (2005) argued that incentives and behaviour of audit partners might change significantly under a mandatory rotation regime. The findings in Chen et al. (2008) may not be generalised to the current mandatory audit partner rotation period. Chi et al. (2005) investigated the effectiveness of mandatory audit partner rotation in promoting audit quality, using the Taiwanese data, with abnormal working capital accruals as proxies. Their findings revealed no significant difference in the audit qualities of companies that were subject to mandatory audit partner rotation in 2004 and the audit qualities of companies that were not subject to mandatory rotation during the same period. They also found that the audit qualities of companies whose audit partners were rotated in 2004 were lower than the audit qualities of those same companies in 2003 under the old audit partners. Their results failed to provide support for partner rotation and confirmed their arguments that those findings based on data from before the rotation period may not be generalised to the current mandatory audit partner rotation period.

### **2.6.3 Summary**

Studies that used behavioural and archival data documented conflicting evidence regarding the question of whether or not a long auditor-client relationship will impair auditor independence. The conflict of findings in the archival studies might be due to the use of surrogates or proxies to measure ‘real’ independence impairment, “the extent to which it is an appropriate and accurate proxy presents a limitation” (Sharma and Sidhu 2001, p. 621). The inconsistencies among the results produced by these studies may suggest opportunities for future research.

It can be argued that the impact of long relationships between auditors and their clients on auditor independence is a matter of perception and that those users who depend on the audited financial statement need the assurance that auditor independence exists. If the auditor is not seen to be independent, the users will have less confidence in their financial statements and the auditor’s opinion will be of no value.

Nevertheless, both archival and perceptual studies have examined two types of auditor rotation: audit firm and audit partner rotations. The rotation of audit partner rather than the entire audit firm is an interesting compromise position and seems preferable in terms of cost and benefit arguments. It is also mentioned that both audit firm and partner rotation policies have been implemented in many countries, though the precise benefits of each such rotation solution are still not clear.

Apart from long audit tenure, it is also argued that the level of fee dependence by an auditor on a single audit client may pose a threat to auditor independence. Thus, the subsequent section will review the literature regarding auditor's fee dependence on a single audit client.

## **2.7 Financial Dependence on a Single Audit Client**

It has been argued that one of the greatest conflicts of interest for an auditor is the payment of audit fees. Client management are said to have a degree of power over the auditor since they pay their audit fees (Firth 1980). In order to reduce the risk of losing fees from an engagement, auditors may be driven to fulfil the wishes of their clients and even collaborate in fraudulent activities (Gavious 2007). It is also likely that auditors' mental attitude, investigative and reporting freedom will be influenced when a particular client is important to their portfolio (Flint 1988). As a result, corporate participants, regulators and interested parties expressed concerns about the negative impact of auditors receiving significant fees from a single client. Auditors' dependence on a single client would cause them to rely economically and financially on that client and his or her objectivity might be compromised, especially in a situation of conflict.

Recent studies seem to focus more on the impact of NAS fees on various measures of auditor independence. This situation is motivated by the legislators' reaction and beliefs that NAS fees are lucrative for audit firms and are thus viewed as a potential threat to auditor independence (Khurana and Raman 2006). Audit fees are observed as less likely to jeopardise independence since audit firms operate in competitive audit markets, thus

making their audit fees theoretically replaceable (Craswell et al. 2002). However, Khurana and Raman (2006) argued that both audit and NAS fees may contribute to economic bonds emerging because both involve payments to the auditor. Some studies also suggested that if the economic bonding created by NAS fees is argued to adversely affect audit quality, the same argument can be applied to all fees received by the auditor, including the audit fees (Geiger and Rama 2003; Raghunandan et al. 2003; Basioudis et al. 2008).

Khurana and Raman (2006) reported that current data subsequent to the SOX 2002 indicated that NAS fees have declined while audit fees have risen significantly, implying higher profit margins for audit services. Gavigus (2007) also suggested that auditors working in the current setting, where the auditors are restricted in their provision of NAS to audit clients, would try to minimise the risk of losing audit fees. As such, it may be inappropriate to place emphasis only on NAS fees as a potential threat to auditor independence since auditors may also “face an ‘encouragement’ to comply with their clients’ wishes through higher audit fees” (Gavigus 2007, p. 454).

Reynolds and Francis (2001) concurred with the above arguments, stating that, irrespective of whether the source of fees is from auditing or consulting, fee dependence is an inherent part of auditor-client contracting and larger clients create greater economic dependence. They highlighted evidence that just 26% of SEC clients purchased consulting fees from the Big Five auditors (1999 data) and that only 3% had consulting fees that exceeded audit fees<sup>5</sup>. They suggested that audit fee dependence on a large client posed a far more pervasive threat to auditor independence than did consulting fee dependency.

The extent of an audit firm’s fee dependence on a single client can be considered on the basis of the total revenues of the audit firm’s local office or on its national office (Reynolds and Francis 2001). Reynolds and Francis (2001) explained that, when the base used is the total revenues of the Big Five accounting firm as a whole, the loss of any single client

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<sup>5</sup> Data in Appendix B of the SEC’s proposed rule restricting consulting services by audit firms to their audit clients. Refer <http://www.sec.gov/rules/proposal/34-42994.htm>.



could only have a small impact on the analysis<sup>6</sup>. However, when the base used is the local office carrying the primary engagement responsibility, the impact could potentially be substantial. Thus, the loss of a single large client could result in a significant loss to the local office total revenue and may lead to staff reductions and lower partner's compensation.

At present, the APB in the UK rules that if the size of total fees received from a single audit client represents more than 10% of the practice total income (or individual partner or office income - depending on how profit was allocated), this association is presumed to compromise auditor independence (APB 2010). The IFAC is also concerned about the audit firm's and the audit partner's fee dependency on a single client, as these situations may create a self-interest or an intimidation threat during the auditing of financial statements. In 2009, the IFAC included section 290.222 - imposing a limit of 15% on the total income that an audit firm may receive from a single audit client (IFAC 2009).

As proposed by Reynolds and Francis (2001), Craswell et al. (2002) used Australian auditors' fee data in examining the threats to auditor independence due to fee dependence at both the national firm level and the local office level. They used the auditor's propensity to issue a qualified opinion and the propensity to issue serious qualifications as indicators that auditors exercised independent judgments. The rationale was that if fee dependence were to affect auditors' independent judgment, they would be less likely to issue qualified audit opinions. They found that neither of the audit fee measures posed a threat to auditor independence.

Similarly, DeFond et al. (2002) and Callaghan et al. (2009) found no evidence of an association between audit fees and auditor reporting, while Basioudis et al. (2008) and Geiger and Rama (2003) found contradictory evidence. All of these studies investigated whether the magnitude of audit and NAS fees affected the auditors' decision to issue GC

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<sup>6</sup> Reynolds and Francis (2001) used the term Big Five since the study used data before the merger that created PriceWaterhouseCoopers in 1998 which reduced the then Big Six group of leading public accounting firms to the Big Five.

opinions for samples of distressed companies in the US and the UK. Unlike Craswell (2002), these studies only used a measure of audit fees based on total client fees. Because of the different fee measurements used, these results are not strictly comparable.

The behavioural studies have long emphasised concerns over fee dependence on a single audit client. Firth (1980) examined the perceptions of both preparers and users of financial statements through a questionnaire postulating 29 auditor-client relationships with two statements focusing on fee dependence. The results of the study showed that, should an accounting firm receive 15% of its gross fees from one client, and should one office of a large national accounting firm receive 20% of its gross fees from one client, auditor independence would be affected from the perspective of all respondent groups. The user groups (loan officers and financial analysts) appeared more sceptical as to this issue, while the CAs from smaller firms showed the least concern. However, the use of 20% as a benchmark of fee dependence from one audit client can be considered as high since the limit is 10% of the firm's total income from an audit client. In his subsequent study, Firth (1981) used a 15% limit and found similar results.

In Germany, Dyxhoorn and Sinning (1982) used multiple audit fees to a firm's total revenues thresholds between 5% and 75%, discovering that more than 80% of respondents believed that auditors would be considered independent if receiving 10% of their audit fees from a single client. However, the percentages dropped to 30% and below 10% when auditors increased their audit fees to 25% and 50% of their total gross fees from a single audit client.

Shockley (1982) argued that the adverse impacts of NAS, competition among audit firms and audit firm size on auditor independence were associated with the size of audit fees. However, Gul (1991) refuted this argument when he found no significant interaction between audit fees and all other factors in his experimental survey of bankers' perceptions of the auditor's ability to resist management pressure in an audit conflict situation. The factor variables (size of audit fees, NAS and competition) were combined into 16 cases in which audit fees were tested at two levels: significant and insignificant. The analysis of

variance (ANOVA) results also revealed that the most important effect was the size of audit fees. The author suggested that audit fees alone may have a damaging effect on the bankers' perceptions of auditor independence and that an audit firm could become economically dependent upon a client even without the provision of NAS. However, since in Gul (1991), only a small sample of 72 bank lending officers were selected and 49 usable responses analysed, it was difficult to generalise the results outside of the sample selected.

In a similar study, Gul and Tsui (1992) hypothesised and tested the notion that the size of audit fees was one of the major determinants of bankers' perceptions of auditors' ability to resist management pressure. Using an experimental survey method and a non-random sample of Hong Kong bankers as subjects, their ANOVA results revealed that the size of audit fees was significantly associated with the bankers' perceptions. In particular, when the size of audit fees was significant, auditors were perceived to lack independence. This was consistent with Gul's (1991) findings.

Bartlett (1993) reported questionnaire results of US CPAs' and bankers' perceptions of auditor independence in 10 different situations, which included sizes of audit fees; at 1% of total CPA revenues and at 40% of work supervised by an audit partner. The results showed that the 1% case was rated much higher in perceived independence than the 40% case. This result is expected since the size of audit fee at 1% of total CPA revenue can be considered too low to measure fee dependence. The two cases were not mutually exclusive since a client may represent 1% of firm revenue and 40% or more of a partner's workload. However, the significant reduction in perceived independence, given the knowledge of the fee relationship to the individual partner, raised serious doubts particularly for the banker group, about the individual partner's ability to make unbiased decisions about a significant client. These findings provided support for the rules by the APB and IFAC, limiting the total income that both an audit firm and an audit partner may receive from a single client.

In another study, Teoh and Lim (1996) found that large audit fees received from a single client were the most important variable in their ANOVA. The study examined whether factors such as size of audit fees, existence of an audit committee, NAS, long audit tenure

and disclosure of NAS fees, affected auditor independence perceptions of Malaysian accountants. The results also revealed that the level of confidence in independence was highest when the fee dependence situation was excluded from the interactions.

The results of the studies by Beattie et al. (1999), Alleyne et al. (2006), Al-Ajmi and Saudagaran (2011) and Dart (2011) were also consistent with prior perception studies as these studies found that economic dependence was perceived as the strongest threat factor affecting independence. These studies used fee dependence on a single client of 10% of the firm's total revenue. The respondents in Beattie et al. (1999) were also indifferent regarding whether the fee dependence was based on local or national office. Most recently, Beattie et al. (2013) found that economic dependence factors were perceived as significantly enhancing audit quality. On the other hand, the results in Abu Bakar et al. (2005) contradicted most of the prior findings when they found that Malaysian bankers ranked size of audit fees as the least important factor affecting auditor independence even though in general the respondents perceived that the size of audit fees would have a damaging effect on the independence of the auditor. Abu Bakar et al. (2005) claimed that since the information on audit fees' percentage of the total firms' revenue was not available, any information in the financial statements concerning audit fees alone is meaningless to Malaysian bankers.

### **2.7.1 Summary**

It can be concluded that prior research seem to have overlooked the potential of independence impairment due to fee dependence on a single client. This is evident from a lack of recent archival studies in this area and not many perceptual studies have included fee dependence as one of the independence impairing factors. However, conflicting results were documented from the archival studies reviewed. Meanwhile, the evidence from the majority of the perceptual studies was more consistent with the concern of the regulators that fee dependence on a single client will negatively affect the independence of the auditor. The credibility of the auditor depends not only on facts but also, just as importantly, on perceptions of independence. Thus, if auditors' fee dependence on a single

client does not impair independence in reality, the users who depend on the audited financial statement still need the assurance that auditor independence exists.

The following section examines whether the provision of NAS to audit clients has the potential to impair auditor independence.

## **2.8 The Provision of Non-Audit Services (NAS)**

The provision of NAS has been mostly debated as a factor that has a potential impact on auditor independence. The controversy surrounding an audit firm providing NAS to its audit clients centres on its ability to remain objective when auditing clients' financial statements while at the same time providing consulting services to those clients. The income from NAS could make an audit firm economically dependent on an audit client and this dependence might reduce the auditors' willingness to challenge possible misstatements of a client's financial statements (Kinney et al. 2004). The auditors may also be reluctant to confront the client's use of questionable accounting techniques for fear of losing their NAS income (Mitra 2007). Additionally, the auditors may also tend to make difficult audit decisions in favour of their clients (Basioudis et al. 2008), sacrificing their objectivity in order to retain a high NAS fee-paying client. The auditors may also develop too close a relationship with their clients during such engagements, which may ultimately make it difficult to remain independent (Schulte 1965).

On the other hand, Goldman and Barlev (1974) suggested that the provision of NAS makes auditors more useful to their clients and thereby increases their value and relative power over the clients. Therefore, the auditors are better able to resist management pressure and are more likely to maintain their independence. Mitra (2007, p. 87) supported this argument and stated that the development of an industry-specific knowledge base and related financial expertise makes auditors of such firms "indispensable to their clients". This situation would lead to clients' dependence on the auditors, which could strengthen independence, reduce client pressure and mitigate auditors' reporting biases. Similarly, Simunic (1984) added that the provision of NAS by auditors could enhance the auditors'

knowledge of the client, resulting in a more efficient and effective audit. The provision of NAS could also increase audit firms' reputational capital (Arrunada 1999; Kinney et al. 2004). Consequently, auditors would not jeopardise their firms' reputational capital to satisfy the demand of the clients, instead increasing incentives for audit thoroughness and independence in audit reporting decisions.

Prior research has suggested that audit firms should be prevented from offering such services and to act exclusively as auditors in order to safeguard independence (Mitchell et al. 1993, cited in Canning and Gwilliam 1999). Mautz and Sharaf (1961), however, have long rejected this idea and concerned that it would damage the carefully nurtured relationship between the audit firm and audit client. As an alternative to a total ban on provision of NAS to audit clients, it has been recommended that the staff for audits and NAS should be separated, or that NAS should be 'spun-off' into different divisions within the audit firms (Mautz and Sharaf 1961; Hillison and Kennelley 1988). Mautz and Sharaf (1961) believed that such an action could indeed protect the auditors from unrecognised pressures and influences and help in building a strong structure in the profession concerning independence. Arrunada (1999) also agreed that the use of different divisions responsible for different services will safeguard independence.

Hillison and Kennelley (1988) further extended three other alternatives to a total ban on NAS provision to audit clients: i) offer NAS only to non-audit clients, ii) impose a ban only on selected types of NAS to audit clients, and iii) insist on full disclosure of the amounts of NAS purchased from the auditors in the clients' financial statements. Hillison and Kennelley were in favour of the full disclosure alternative, in that it would be less resisted by audit practitioners, would offer an effective means of monitoring NAS purchased by audit clients and the clients would be willing to disclose NAS information in their financial statements.

Following those events concerning Enron and WorldCom, and the collapse of Arthur Andersen, the enactment of SOX 2002 has placed more severe restrictions on the provision of NAS in the US. SOX 2002 subsequently banned audit firms from providing any

financial information system design and implementation services (FISDI), internal audit and ‘certain other services’ to their audit clients. The legislative approval of Section 201 of the Act, prohibiting the external auditors from providing certain NAS to the audit client was deemed necessary to safeguard auditor independence (SOX 2002). Those ‘certain other services’ include bookkeeping, appraisal or valuation services, actuarial services, management functions and human resources, broker-dealing, investment advice or investment banking, legal and expert services unrelated to the audit and any other services that the Public Company Accounting Oversight Board (PCAOB) determines should be restricted. The act also requires prior approval by a registrant’s independent audit committee of any NAS allowed by the law. The act restricts the above types of NAS based on the SEC’s (2003) principles of independence that auditors cannot:

- i) function in the role of management for their clients,
- ii) audit their own work, and
- iii) serve in an advocacy role for their clients.

The recent IFAC Code of Ethics (IFAC 2009) however is less rigid. The provision of accounting and bookkeeping services to listed audit clients is not allowed by the Code except in emergency situations<sup>7</sup>. Emergency situations include other unusual situations when it is impractical for the audit client to make other arrangements. This may be the case when:

- (a) only the firm has the resources and necessary knowledge of the client’s systems and procedures to assist the client in the timely preparation of its financial statements,

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<sup>7</sup> In emergency situations or other unusual situations, the following conditions shall be met; a) those who provide the services are not members of the audit team, b) the services are provided only for a short period of time and not expected to recur, and c) the situations are discussed with those charged with governance (IFAC 2009).

- (b) a restriction on the firm's ability to provide the services would result in significant difficulties for the client.

However, similar to the SOX 2002, IFAC (2009) also proscribed the provision of information technology systems and internal audit services if these services are significantly related to the production of the client's financial statements and internal controls over the client's financial reporting.

Consistent with the research in the area of long audit tenure, research on NAS provision has been extensively examined from the perspectives of the behavioural approach and the archival approach. The following sub-sections review the two approaches.

### **2.8.1 Studies using a Behavioural Approach**

The early literature concerning NAS provision to audit clients mainly used the behavioural approach. Shockley (1981) added evidence to the debate when the results of his study indicated that, overall, audit partners (CPAs), financial analysts and loan officers perceived those CPA firms who provided NAS to audit clients were more likely to lose independence than those which did not. NAS was defined in this study as the design and installation of financial and cost accounting systems, budget and inventory control and other accounting-related information systems. This study used an experimental design approach and the results of ANOVA further revealed that the CPAs from smaller firms weighted the effect of NAS on auditor independence more heavily than did the Big Eight respondents. Since Shockley only focused on NAS related to systems design work, generalisation of the results to the full range of services normally provided by large audit firms was not supported.

Pany and Reckers (1983) examined the impact of providing three types of NAS (tax preparation, acquisition review and systems design) on auditors' ability to remain independent. In this research, they emphasised the issue of financial dependency arising from providing NAS to audit clients. Using an experimental approach, they requested



company directors to evaluate 18 cases, in each of which case, they asked whether an independent auditor should be hired to perform specific NAS. They found that company directors were less likely to approve all types of NAS proposals at 40% of audit fees. As the amount of NAS increased from 10% to 40% of audit fees, the directors perceived a greater risk of the independence of the auditor being impaired.

Pany and Reckers (1983) also tested whether a routine NAS provision such as tax preparation would lead to perceptions of compromised independence when compared to non-routine services such as systems design work. They found that company directors perceived systems design work as having more adverse effects on auditor independence than tax preparation and acquisition review services. However, similar to Shockley (1981), Pany and Reckers (1983) could not generalise their findings to other types of NAS. Schneider et al. (2006) pointed out that the setting up of comparison studies that use a wide variety of non-overlapping NAS is difficult and that conflicting results in prior studies may suggest that the specific type of NAS does matter. Thus, comparing the results of Shockley (1981) and Pany and Reckers (1983) may be a complicated since the types of NAS tested in both studies did not exactly match.

McKinley et al. (1985) offered a different approach to studying NAS by providing respondents, loan officers, with a loan application package, asking them to review the information and make a loan recommendation. McKinley et al. tested the provision of NAS by auditors at two levels: when no NAS was provided and when NAS comprised 30% of audit fees. The results were inconsistent with prior studies since they found no significant difference in loan decisions whether or not NAS had been provided. This finding may be due to the loan applicant being a relatively small client. Furthermore, the use of Big Eight audit firms in most of the samples failed to significantly affect the loan decisions.

Using a similar approach to McKinley et al. (1985), Pany and Reckers (1988) extended their experiments to financial analysts and varied the level of NAS provisions (0%, 25%, 60% and 90% of the average annual audit fees respectively). The authors used a case

company that was publicly traded. The results revealed that loan officers were more likely than the other groups to grant a loan when NAS fees were at 25% of audit fees, while financial analysts showed no significant difference in their investment decisions at any of the NAS levels under study. Unlike the findings in McKinley et al. (1985), the loan officers in this study seemed to place some value on the NAS provided by the auditors and thus provided some support for Simunic's (1984) argument that NAS provision to an audit client could enhance auditors' knowledge of the client, resulting in a more efficient and effective audit.

In another US study, Bartlett (1993) asked 300 loan officers and 300 CPAs to indicate their perceptions of auditor independence on a scale of 0 (not independent at all) to 100 (completely independent) in ten different situations, four of which related to the provision of NAS. Using a questionnaire survey method, the results of the study showed that in each NAS situation, loan officers perceived significant reductions in auditor independence compared to CPAs. The results of the four situations were compared against results for when auditors provide audit services only. Bartlett concluded that users of financial statements may be uncertain about auditor independence, while auditors were overly confident about their ability to remain independent in the face of all circumstances. Even though the study examined the impact of different types of NAS individually, it failed to emphasise the fact that different type of NAS may affect independence differently. This issue is discussed in Quick and Warming-Rasmussen (2005, 2009).

An early UK study, Firth (1980) examined 29 auditor-client relationships, five of which clearly indicated situations where the auditor provided NAS to audit clients. The results of the study revealed that the users (financial analysts and loan officers) were more sceptical of auditor independence, even though all groups (including auditors and accountants working in the industry) perceived that NAS would have a negative impact on auditor independence. In his subsequent study, Firth (1981) found that bank loan officers granted lower loan offers when the applicants' auditors provided NAS. These results were inconsistent with McKinley et al. (1985) and with Pany and Reckers (1988).

Despite the difficulty of comparing the results of studies that used non-overlapping NAS, the literature documents more consistent evidence concerning the effect of having separate personnel or divisions in performing the audit and NAS. Pany and Reckers (1984) extended their prior study by investigating the effect of six types of NAS (types that were then grouped into accounting and non-accounting related services) on auditor independence through a mail questionnaire survey of financial analysts and corporate stockholders. They reported that the independence concerns decreased when NAS were performed by a separate division of the CPA firm, rather than by the very same staff that conducted the audit.

Similarly, Canning and Gwilliam (1999) found that the threat to independence was significantly less when NAS were provided by a separate department within the audit firm and to non-audit clients only. But, they also found that the respondents in their study (which consisted of corporate lenders, investment managers and financial analysts) were not in favour of prohibiting audit firms from providing NAS to audit clients as a means of maintaining auditor independence. Lowe et al. (1999) further reported that the separation of audit firm staff performing outsourced internal audit from those performing financial statement audits had a significant positive impact on the perceptions of financial statement users and loan approvals. The findings in Swanger and Chewning (2001) were also consistent with the results in prior studies when they found that analysts' perceptions of auditor independence were higher when internal audit services were provided by staff from a different division of the CPA firm.

While prior studies used questionnaire surveys and experimental methods, Canning and Gwilliam (1999) used a combination of mail questionnaires and semi-structured interviews when investigating the effects of the general provision of NAS on users' perceptions of auditor independence in Ireland. They also managed to obtain a high response rate of 75.5% which provided superior support for the results. The mixed methods or 'triangulation' used in the study, allowed in-depth coverage of the topic and offered the opportunity to probe deeper into the nature of the perceptions held.

In an experimental survey in New Zealand, Gul (1991) examined the impact of NAS on bankers' perceptions regarding auditors' ability to resist management pressure in an audit conflict situation. In his study, NAS were restricted to two levels: those provided by, and those not provided by, the audit firms to their clients and were defined similarly to those distinctions used in Shockley (1981). The findings showed that auditors providing NAS were perceived to be more likely to favour the client in resolving a conflict than auditors not providing NAS. Gul suggested that auditors providing NAS may become employees of the client, or be in a position of auditing their own decisions which may cause adverse effects on auditor independence.

Further evidence by Beattie et al. (1999) indicated that users of financial statements (financial journalists) in the UK were more concerned about the risk of independence impairment than were auditors and financial directors when NAS were provided to audit clients at all levels tested: 100%, 50% and 25% of audit fees respectively. In response to these findings, the authors interpreted that the user group would have no systematic knowledge of the amount of NAS generally provided by the auditors and that they would therefore be more concerned particularly when the amount of NAS increases as a percentage of audit fees. Overall, the study found that NAS were perceived as a dominant threat factor that may cause the auditor to compromise his independence. Replicating the approach undertaken by Beattie et al. (1999) in Barbados, Alleyne et al. (2006) and Bahrain, Al-Ajmi and Saudagaran (2011) also reached similar findings.

Evidence from Denmark by Quick and Warming-Rasmussen (2005) further supports these prior results; they found that most of the financial statement users in their study believed that NAS provision reduces the trust held in an auditor's independence. Questionnaire surveys were sent to 927 respondents (state authorised auditors, managing directors, loan officers, private shareholders and business journalists). Their findings revealed a high majority of auditors (86%) disagreed that NAS may cause a lack of independence, whereas a majority of business journalists (81%) agreed that NAS may lead to independence impairment. However, their findings on whether the separation of staff for audit and NAS increases the credibility of auditing were inconsistent with prior findings. Only business

journalists perceived that staff separation has a positive impact on auditor independence while auditors (67%) failed to acknowledge the benefits of staff separation. The authors concluded that the results may be due to cultural differences; in Denmark, professionals may be considered to prefer negotiations and consensus rather than conflict and familiarity issues arising from NAS are not viewed as problematic.

Quick and Warming-Rasmussen (2005) also examined the impact of different types of NAS on independence perceptions. While most prior studies grouped several types of services as one NAS, this study analysed four types of NAS separately. The four types of NAS included were: FISDI, the recruitment of senior management, legal services and accounting-related services. The results indicated that all the types of NAS were perceived as independence-impairing, with accounting-related services having the least negative impact.

Quick and Warming-Rasmussen (2005) also investigated respondents' perceptions of the maximum amount of NAS fees (as a percentage of total fees from a particular client) that is acceptable (if exceeded, reduces perceived independence). Respondents were also requested to state their expectations of actual NAS fees (as a percentage of total fees from a particular client) that the auditors have been earning from an audit client. The results showed that only auditors perceived that the actual fees from NAS that they have been receiving from a particular audit client have not exceeded the limit of NAS fees allowable. All other groups perceived otherwise. In addition, the auditors perceived the highest limit of NAS fees percentage (67%) as the maximum limit whereas private shareholders perceived 25% and business journalists perceived the lowest (10%) limit. The authors concluded that the auditors tended to be less concerned about independence impairment due to their knowledge of audit tasks. Quick and Warming-Rasmussen (2005) also described business journalists as having a "very critical attitude" (p. 155) since it was this group that always perceived the greatest threat in all of the factors tested.

In their subsequent study, Quick and Warming-Rasmussen (2009) extended their prior research by exploring private investors' perceptions of NAS and its impact on auditor

independence in Germany. Members of German academic investment clubs from two universities were invited through e-mail to complete an online survey resulting in 98 usable responses. Similar to prior findings, the authors found that, in general, private investors believed that NAS reduces the trust placed in auditor independence. The authors further examined a comprehensive list of 19 types of NAS and the results revealed that the respondents tended to perceive a negative impact on independence for all services, with only two services (accounting information services and forensic services) being perceived to have 'weak' effects on independence. Despite the fact that many types of NAS are not explicitly forbidden by the regulations, these services were still perceived as independence-impairing. In terms of the staff separation effect, the results confirmed the findings in prior studies that the separation of auditing and NAS staff increased perceived independence. Finally, similar to the finding in their Denmark's study, the authors found that German investors perceived a lower NAS percentage allowable (an average of 28% of total fees) whereas the current percentage of NAS fees in the auditing industry was perceived at an average of 47%. The findings further confirmed prior empirical research that the risk of independence impairment increases with proportionally larger NAS fees.

The above study, however, suffers from several limitations. First, the study only focused on private investors' perceptions. Thus, the results are only valid to this group and cannot be extended to other financial statement users such as loan officers and financial analysts. Second, the respondents selected in this study were from an academic investment club where only 19% of the respondents were shareholders. The results of the study may be questioned and may not be considered completely representative of private investors' perceptions of the issues under study. Third, since the respondents were mainly students from different backgrounds (but with similar interests in terms of investments), they may not know about the different types of NAS included in the questionnaire. Due to the different backgrounds among the respondents, the validity of these students' answers may also be questionable.

Early Malaysian studies on NAS provision included those by Gul and Yap (1984) and Teoh and Lim (1996). Based on a questionnaire survey, Gul and Yap (1984) reported that

the majority of respondents which consisted of public accountants, managers, bankers and shareholders, perceived that the expansion of audit firms into NAS fields reduced their confidence in auditor independence. The quantity of shareholders who shared similar views was significantly lower than that of other respondents groups. However, the results of the shareholders' perceptions may be considered weak due to the small sample size (with only 34 respondents in the shareholder group). The results also showed that the majority of respondents perceived that a separate disclosure of audit and non-audit fees would provide a better understanding of the relationship between the auditor and the client.

Teoh and Lim (1996) disclosed that the provision of management consulting services was ranked as the second most important factor (after large audit fees) which may impair perceptions of auditor independence. The study also revealed that the level of perceived independence was increased when NAS fees were disclosed in the published accounts and that the level of confidence was highest in the absence of NAS. The results also showed that the perceptions of impairment of auditor independence were more pronounced among the non-PAs than among the PAs.

The two Malaysian studies on NAS provision may be considered dated as both studies were conducted more than 25 years ago and prior to the major reform in corporate governance and accounting practices that took place after the Asian financial crisis hit the country in 1997. In addition, the studies only surveyed a very general overview of NAS practices. In-depth study on this issue would provide a better understanding on the NAS practices in the Malaysian audit market.

In another Malaysian study, Abu Bakar et al. (2005) used a questionnaire survey to examine the perceptions of loan officers regarding several potential factors that may impair auditor independence, including the provision of NAS. Similar to prior Malaysian studies, this research only focused on the provision of general NAS by the auditors to their audit clients. Details such as the magnitude of NAS fees or fee ratios and NAS disclosure were not examined in this study. Interestingly, the loan officers viewed NAS as one of the least important factors capable of affecting auditor independence even though a majority of the

respondents (86%) agreed that NAS provision has the potential to impair auditor independence. The authors did not offer any explanation or reason for such findings.

Law (2008) offered further evidence based on perceptions of independence with respect to Hong Kong's Big Four and non-Big Four auditors, examining whether their perceptions were affected by their ranks in the audit firms. The results were consistent with prior findings, with auditors agreeing that providing NAS to audit clients could compromise their independence. Law also discovered that audit managers' rating were significantly higher (many viewed NAS as enhancing independence) than the staff's and partners' ratings. Law interpreted that since audit managers are highly sought-after in their market, they could easily change jobs which may indirectly affect their work commitment. The partners were found to be sceptical which might indicate that firm's reputation was important and they might try to avoid litigation with regards to NAS provision. Since the research is recent and the respondents are auditors, it can be said that they are well informed and knowledgeable on this issue. Nevertheless, their agreement may be due to merely agreeing to the current audit standards which may be reasonable since these respondents might want to protect both the reputation of their firms and that of their profession.

In a recent US study, Colbert et al. (2008) attempted to reconcile the conflicting findings in recent archival studies (on the relationships between NAS fees and indicators of auditor independence in fact) and the findings in perceptual studies. To achieve this objective, the authors used an experimental approach with a between-subjects design and the subjects in this study were loan officers. Two types of NAS were included, namely; FISDI and tax services. The ANOVA and regression results revealed that FISDI services by auditors did not affect lenders' perceptions of independence, financial statement reliability and loan decisions. On the other hand, when tax services were provided, lenders perceived that the auditors were less independent, that their financial statements were less reliable and that lenders were less likely to approve the loan. The study also hypothesised that the joint provision of FISDI and tax services will further reduce lenders' independence perceptions.



The hypothesis was rejected since the results indicated no statistically significant interactions between the two NAS and the dependent variables.

From the perspective of UK investors, a recent study by Dart (2011) provided further support to prior UK studies (i.e. Firth 1980; Beattie et al. 1999) in that the provision of NAS caused concern in relation to auditor independence. The study also examined 10 types of NAS and found that those NAS that involve the auditor providing accounting-related services (i.e. internal audit services and bookkeeping) that caused the most concern. Services such as tax services, human resources and FISDI caused the least independence concern. The study also revealed that the majority of investors agreed with the banning of audit personnel providing NAS and that a separate division of the same firm should be allowed to provide NAS.

Finally, Beattie et al. (2013) examined whether disclosures of NAS fees paid to the auditor with a detailed breakdown and whether policies and procedures established to ensure that audit partners and staff are not rewarded or promoted for selling NAS to audit clients would enhance audit quality in the post-SOX 2002 setting. The results of their questionnaire survey showed that the two NAS rules were perceived to have no significant effect on audit quality and thus failed to provide support for the earlier disclosure suggestion made by Hillison and Kenneley (1988).

The following sub-section reviews the archival studies that examined the impact of NAS provision to an audit client regarding ‘factual’ independence. Auditor independence in fact is unobservable (Beattie et al. 1999) and is impossible to measure directly. The archival studies in the following sub-section used surrogates in an attempt to measure ‘real’ independence.

### **2.8.2 Studies using the Archival Approach**

Consistent with the literature of long audit tenure, the use of archival data has been dominating the recent literature on NAS. Some of these studies used earnings management,

as an indicator of low-quality financial reporting, as evidence of independence impairment. They utilised abnormal discretionary accruals or the propensity to meet earnings benchmarks as surrogates for earnings management (e.g. Frankel et al. 2002; Ashbaugh et al. 2003). Other research examined the association between NAS fees and restatements (e.g. Raghunandan et al. 2003; Kinney et al. 2004) as reflecting a low quality financial reporting. Some studies focused on audit quality and a low propensity to issue GC opinions, serving as a proxy for the impairment of an auditor's independence position (e.g. Sharma and Sidhu 2001; DeFond et al. 2002).

The results of studies that used accounting accruals and/ or the propensity to beat analysts' forecasts to measure reporting quality are mixed. A prominently cited US study by Frankel et al. (2002) found that firms with greater ratios of NAS fees to total fees were more likely to report larger abnormal accruals and to just meet or beat analysts' forecasts. Even though they only studied a short period of data (from February 2001 to June 2001), their study was the first academic study that reported evidence to suggest that auditors will compromise their independence if at the same time they provide NAS to their audit clients. Frankel et al. interpreted their results as a strong support for the regulators' concerns that the provision of NAS may impair auditor judgments and lower the quality of financial information. Subsequent studies, however, found contrary evidence, thus questioning the appropriateness of the conclusion in Frankel et al. (2002) (Ashbaugh et al. 2003; Chung and Kallapur 2003; Reynolds et al. 2004; Mitra 2007; Cahan et al. 2008)

Larcker and Richardson (2004) argued that studying audit and NAS fees in isolation from other governance mechanisms may present an incomplete analysis on how the different fees may affect the earnings quality. The role of the external auditor is one of many potential mechanisms designed to mitigate the inherent agency problems in public listed companies. Larcker and Richardson (2004) found consistent evidence of a statistically negative association between the level of NAS fees and accruals. This negative relation was strongest for client firms with weak governance (less independent boards, low institutional holdings and high insider holdings). Their results provided support for the argument that weakness in corporate governance appeared to be an important determinant

of the relation between measures of auditor independence and earnings quality. Their results also implied that auditors are concerned about their reputation and that they are less likely to allow unusual or abnormal accrual choices for firms where they have the greatest financial interest or dependence on the audit client particularly when client firms have weak governance structures.

The prohibition of certain types of NAS to audit clients seems to imply the regulators' and legislators' presumption that providing NAS will compromise auditor independence, leading to lower quality audits and reviews and increasing the likelihood of financial reporting that violates generally accepted accounting principles (GAAP) (Kinney et al. 2004). Some of these GAAP violations are revealed through restatements of previously audited financial statements. Raghunandan et al. (2003) advocated that financial statement restatements are viewed as audit failures resulting from the increasing reliance of audit firms on fees from NAS, thus providing a means for a direct test of the association between NAS and audit quality.

Raghunandan et al. (2003) investigated the association between firms that issued restated financial statements in 2000 and 2001 and the unexpected values of NAS fees, fee ratios and total fees paid to the auditors. However, their results failed to find any significant differences in the unexpected NAS fees between firms with restatements and firms without restatements. Similarly, Bloomfield and Shackman (2008) also found limited evidence that firms with higher NAS fees were more likely to restate earnings. Their report cast doubt on the public perception that NAS impair auditor independence.

As compared to Raghunandan et al. (2003) and most prior research examining NAS fees on aggregate, Kinney et al. (2004) investigated whether the specific NAS fees (FISDI, internal audit and tax) and unspecified NAS, paid to a publicly held company's audit firm in the US from 1995 through 2000 were associated with the restatement of previously issued financial statements. They found no significant evidence between fees for FISDI or internal audit services and restatements. Their findings can be considered weak since only 5% or fewer of the companies in their sample of 432 pairs of restating and non-restating

companies purchased FISDI or internal audit from their auditors. They concluded that the banning of these NAS may only affect a few companies and may not improve the quality of financial reporting. Their results further revealed that the unspecified NAS fee was positively associated with restatements but the nature of the unspecified professional services was not known to the authors. Finally, the study also found a significant negative association between tax service fees and restatements which were mainly purchased by larger companies and those paying lucrative NAS fees.

The negative association between the provision of tax fees and restatements in Kinney et al. (2004) is open to several interpretations. The traditional view is that an increase in earnings restatements may indicate failures of the auditors and severe earnings management by the clients (Larcker and Richardson 2004). The tax fees received by the auditor might be so high that they are willing to overlook any non-compliance with GAAP by the clients. However, Kinney et al. (2004) interpreted their findings as being the result of improvement in audit effectiveness due to NAS through knowledge spill-over, supporting the lack of concern of the regulators over the provision of tax services to audit clients. In addition, since the result showed that the negative association was mainly driven by larger companies and by those paying lucrative NAS fees, more explanations could be offered if the governance structures of these firms were also assessed.

Apart from financial restatements, auditor independence is also closely related to the issue of audit failure and legislators have focused critical attention on situation in which companies filed for bankruptcy without receiving a prior GC opinion (Geiger and Raghunandan 2002). The auditors are responsible for informing the shareholders by issuing GC modified opinions if there is strong evidence that could cast doubt on the reasonableness of the client's GC assumption<sup>8</sup>. The fundamental argument in the auditor independence debate is that the propensity of auditors to issue GC opinions, when such

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<sup>8</sup> ISA 570 Going Concern provides guidance on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption for the preparation of the financial statements.

opinions are warranted, is lower when auditor independence is compromised (DeAngelo 1981a).

The empirical findings in the extant literature on the relationship between GC opinions and non-audit fees are mixed. DeFond et al. (2002) examined a sample of distressed companies in the US and argued that the GC opinion decision is most salient among distressed firms. Their results failed to provide evidence of a significant association between auditors' propensity to issue GC opinions and any of their fee measures (NAS fees, total client fees, the NAS fees ratio to total client fees). In a similar study, Geiger and Rama (2003) also found no evidence of a significant relationship between NAS fees and GC opinions. Both studies concluded that NAS fees had no adverse impact on auditor's reporting judgment.

In a recent study, Basioudis et al. (2008) found contradictory findings when studying the relationship between GC opinions and NAS fees using UK data. They found that financially distressed companies with high NAS fees were less likely to receive a GC modified audit opinion, thus supporting the contention that high NAS fees have a detrimental effect on GC reporting judgments for financially stressed UK companies. Sharma and Sidhu (2001) also reported a negative relationship between the tendency to issue a GC opinion and NAS fees in their Australian sample and consistent with the regulators' concerns that NAS provision to audit clients impairs auditor independence. However, Sharma and Sidhu used samples of bankrupt Australian firms, arguing that examining NAS fees and the audit opinions of bankrupt firms is a more appropriate context for testing auditor independence than examining financially distressed firms. Bankrupt companies necessarily show unambiguous financial distress symptoms one year prior to bankruptcy, reaching a threshold of uncertainty and are therefore more likely to receive GC opinions.

In testing whether the results in Sharma and Sidhu (2001) would apply to US data, a recent study by Callaghan et al. (2009) used a sample of bankrupt US companies in examining the relationship between the propensity of auditors to render GC opinions and fee measures similar to DeFond et al. (2002). However, their results failed to observe any association

between GC opinions issued by the auditors and the fee measures tested. They concluded that the conflicting results in prior studies might be not only due to the type of samples selected (distressed or bankrupt companies) but also due to jurisdictional contexts. Geiger and Rama (2003, p. 56) pointed out that “the transference of overseas results to the US audit market is problematic”. Due to different legal environments, auditors in the US might react differently to lawsuits and reputation concerns than in other countries, causing them to report differently when faced with similar NAS fee issues. Schneider et al. (2006) also highlighted that the ratio of NAS fees to total fees differs substantially across countries. Sharma and Sidhu (2001) reported a much smaller ratio than those in US studies. Schneider et al. (2006, p.189) also suggested “something about the type of NAS (the sample differs with respect to the NAS that is commonly provided) produces different responses to the provision of NAS”.

While most of previous studies focused on NAS fees in aggregate, Robinson (2008) responded to Schneider et al.’s (2006) suggestion and examined only the impact of tax services on auditor independence as proxied by GC opinions among a sample of bankrupt firms. The SOX 2002 allows auditor-provided tax services and this implicitly suggests that regulators and legislators in the US believe that auditor-provided tax services are less likely to compromise independence. The results showed a significant positive correlation between the level of tax service fees and the likelihood of issuing a GC opinion prior to the bankruptcy filing. Similar to prior US findings, Robinson found no significant association between the non-tax components of NAS fees and GC opinions.

### **2.8.3 Summary**

Based on the above review, it can be concluded that the literature concerning the provision of NAS and its impact on auditor independence is clearly inconsistent. The results from archival studies that use surrogates to measure ‘real’ independence have been inconclusive. Francis (2006, p. 752) emphasised that, “While this literature is important, it does not - and cannot - determine whether auditor independence is factually impaired by the presence of

NAS.” Instead, these studies only measured the extent of variation in the proxies that is statistically associated with the level of NAS fees.

The findings from perceptual studies revealed that empirical evidence against NAS provision to audit clients appears more convincing than the evidence for it. Nevertheless, the evidence from perceptual studies is mainly outdated and more recent studies would add better understanding to the issue.

The review of archival studies revealed several important areas of NAS, namely: the extent of the economic bond by the auditor on audit clients as measured by the magnitude of NAS whether absolute or proportional that may impair independence; the types of NAS provision; and the impact of disclosures of NAS fees on auditor independence. Similarly, the perceptual studies also tested whether each of these factors have a potential impact on perceived auditor independence. In addition, the perceptual studies also revealed the preference of respondents in relation to whether NAS should be provided by separate personnel or departments, different firms or the auditor should be banned entirely from providing NAS to audit clients. Since no prior perceptual studies have comprehensively examined NAS based on all of the important areas highlighted above, it is the intention of the current study to explore the impact of these NAS areas on perceptions of auditor independence.

The following section examines the practice of ex-auditor’s employment with audit clients which also arguably has the potential to impair auditor independence.

## **2.9 Ex-Auditors’ Employment with an Audit Client**

Prior research has shown that it is not uncommon for auditors to be offered a position in clients’ firms (Imhoff 1978; Koh and Mahathevan 1993; Beasley et al. 2000; Iyer and Raghunandan 2002). This has been called a ‘revolving door’, the practice whereby audit clients hire senior financial reporting executives directly from their external audit firms (Clikeman 1998). Clients often prefer to hire former employees of their audit firms because

the former auditors have the advantage of knowledge of the clients' business, financial reporting processes and other information systems that other candidates outside the audit firms do not have (Beasley et al. 2000). However, following the collapse of Enron in 2001 along with other infamous financial scandals like Global Crossing and Waste Management, the accounting profession has been brought into sharp focus regarding the issue of ex-auditors seeking employment with their audit clients. This is because, in each of these companies the senior accounting and finance officers were hired directly from their external auditors (Menon and Williams 2004; Geiger et al. 2005).

The problem with auditor independence may begin when auditors use their auditing experience as a means of obtaining managerial positions with audit clients. In making this transition or simply looking into the opportunity of re-employment, "a shadow is cast on the auditor's ability to attest independently to a prospective employer's financial statements" (Imhoff 1978, p. 870). Lennox (2005) expressed concern that collusion with an audit client might occur before auditors leave the audit firm since at that time, they may be negotiating a lucrative employment contract with the client, thus making the auditors unwilling to confront the management with problems discovered during that audit. Beasley et al. (2000) also shared a similar concern, claiming that auditors will exhibit a lack of due diligence during the audit of their client's financial statements if they are considering employment opportunities at the client's firm. The lack of due diligence may be evident when the auditors fail to gather sufficient evidence, overlook problems that are apparent from the evidence gathered and improperly agree with the clients preferences particularly those related to accounting principles, estimates and other judgmental decisions (Beasley et al. 2000).

The main problem with employment with an audit client is the ability of current auditors to remain independent when dealing with top managers who were previously fellow auditors (Imhoff 1978; Koh and Mahathevan 1993; Beasley et al. 2000; Fearnley and Beattie 2002). Beasley et al. (2000) argued that current members of the audit team may be reluctant to question their former audit colleague, particularly when the former auditor was previously the audit partner supervising the current audit team responsible for the audit engagement.



Menon and Williams (2004) further added that the current auditors are seen as being likely to trust their former partners because of prior affiliation with the audit firms and that this trust may lead to the auditors' willingness to adjust audit procedures. In their worst case scenario, Fearnley and Beattie (2002) described that an inexperienced current audit partner, or one nervous with losing an audit client, may also not be able to stand up to a bullying or intimidating director, who is himself a former audit manager or an audit partner of the firm.

In response to increasing public scepticism about the practice of companies hiring their auditors and the negative publicity from audit failures such as Enron and WorldCom, regulators particularly in the US have specifically addressed this issue by inserting a provision (Section 206) that forbids public companies from hiring accounting and finance officers from their external auditors for up to one year from the personnel's departure from the audit firms (SEC 2003). The MIA By-Laws (MIA 2010, p. 70) stated that:

*Independence would be deemed to be compromised unless, subsequent to the partner ceasing to be a key audit partner, the public interest entity had issued audited financial statements covering a period of **not less than two years** and the partner was not a member of the audit team with respect to the audit of those financial statements.*

The IFAC also emphasised a concern, stating that taking up an employment with an assurance client may create self-interest and familiarity threats to the audit personnel who may join the assurance client sometime in the future (IFAC 2009).

The following sub-sections will discuss the two approaches that have been utilised in the prior literature on ex-auditors' employment with audit clients, namely; the behavioural approach and the archival approach.

### **2.9.1 Studies using the Behavioural Approach**

Early studies in the area of ex-auditors' employment with audit client used the behavioural approach. Imhoff (1978) provided early evidence that auditor independence was perceived as more likely to be impaired when auditors were in a supervisory position than if they were in non-supervisory positions before accepting employment at a client's firm. Imhoff (1978) reported his research in two stages. The first stage attempted to determine how frequent auditors accepted employment with the clients' firms. He found that 43% of auditors working with the clients were employed in a supervisory capacity in the previous audit of their current employers.

The second stage of Imhoff's research investigated the perceptions of financial statement users (which consisted of bankers and analysts) and auditors in determining whether an ex-auditor's prior position in an audit firm and the time lapse before the ex-auditor accepted appointment with a client, had an impact on auditor independence. Based on the overall response rate of 46%, the results indicated that the time interval between auditing and working for a client did have significant impact on the responses of both groups. Both users and auditors questioned auditor independence more frequently as the time interval decreased but the users consistently perceived client employment to be a greater threat to auditor independence than did the auditors.

Firth (1981) examined whether bankers' intention to grant loans was affected by the following statements; "The recently appointed financial director of a company is responsible for producing its accounts. He was previously a partner (for ten years) in the accounting firm which does the audit." The results revealed that bankers awarded smaller loans to companies that hired their auditors, indicating that the appearance of auditor independence is negatively affected by the auditor-client employment issue.

Koh and Mahathevan (1993) improved upon the study of Imhoff (1978) by examining additional factors affecting concerns about auditor independence. They studied whether the practice of auditors seeking employment with clients was perceived by middle-level managers in Singapore as independence impairing. Consistent with the findings in Imhoff

(1978), Koh and Mahathevan (1993) found that a supervisory position held by an ex-auditor prior to joining an audit client was viewed as impairing independence more than a non-supervisory position held in the past. The results of the study also showed that the shorter the time lapse between auditing a client and joining the client's company, the more the independence of the last audit was questioned by the managers.

For the additional factors tested, the results revealed that the current position of an ex-auditor with a client significantly influenced how the subsequent audit was performed, with independence being questioned more when an auditor accepted a position as a preparer as opposed to non-preparer of financial statements. Finally, the results further revealed that managers perceived the last audit to be less independent when an auditor accepted a position as a preparer of financial statements with the client after issuing a clean audit opinion as opposed to a qualified opinion. This study has added to the literature of auditor independence some insights from the perspective of another Asian country, the area on which the focus of this study rests. Nevertheless, since the sample selected was the middle-level manager group, the results cannot be considered representative of other groups outside the sample.

In another study, Iyer and Raghunandan (2002) examined CPA firm alumni's perceptions about their ability to resolve disagreements with auditors who happen to be their former employers. Their results indicated that the alumni's prior rank as partners or other supervisory positions and the time elapsed since leaving the firm did not significantly alter their perceptions. The study also revealed that the alumni from the audit area were more likely to indicate that they could resolve disagreement more easily if the former CPA firm served as the auditor than the alumni from other areas. These findings provided some evidence to support the regulators' concern about the risk of independence impairment when alumni seek employment with their former clients. The study suggested that auditors may need to be sensitised in order to maintain a professional scepticism when dealing with former colleagues in resolving disputes. This study, however, did not investigate any specific disagreement. The results of the study may have differed if a specific disagreement had been tested particularly if it involves the risk of independence impairment by the

auditors. In addition, the length of time used as ‘time elapsed’ in this study may not be considered to appropriately measure the effective cooling-off period. This is because, the study concerned the length of time between the alumnus leaving the CPA firm and the current date and not the length of time that elapsed prior to the alumnus joining the client company.

Looking at the same issue, Parlin and Bartlett (1994) investigated whether the Big Six (now the Big Four) auditors’ preliminary judgment about materiality estimates were affected by the knowledge that the client’s controller was a former manager of last year’s audit team. In the study, the auditors were given a hypothetical case and asked to make preliminary estimates of materiality. The results showed that, on average, auditors set larger preliminary estimates of materiality when a former audit manager was the client’s controller. To some extent, the findings supported the argument that auditor independence may be compromised because of familiarity and trust on the former partners as echoed by IFAC (2009) and Menon and Williams (2004). However, the result of the study is based on a limited number of responses (37 respondents), thus the generalisability and representativeness of the results might be questionable. In addition, the fact that almost half of the respondents had three years’ or less audit experience may also be seen to affect the results of the study.

Kaplan and Whitecotton (2001) examined the auditor employment issue from a different perspective by providing evidence on auditors’ reporting intentions when faced with the knowledge that an audit manager is considering employment with an audit client. The results of their study indicated that auditors with higher perceptions of responsibility showed stronger intentions to report the employment than did auditors with lower perceptions of responsibility. Conversely, auditors who perceived that the cost of reporting was relatively high showed lower reporting intentions than those perceiving a lower cost of reporting. This study, whilst not directly related to the current study, provides some insight on the challenge of implementing the client employment ethics ruling. Almost 35 years ago, Imhoff (1978) cautioned that any enforcement of the client employment rule would be

difficult since, in reality, audit team members who are involved in this conflict may be reluctant to disclose the situation.

In a survey of members of state boards of accountancy in the US, Wright and Booker (2005) found that the employment of senior auditors in a client company was perceived as damaging auditor independence. Consistent with prior findings, it was found that auditors' prior supervisory position was viewed as impairing independence more than would a non-supervisory position. The study also found that longer cooling-off periods reduced the potential for independence impairment.

A recent study by Dart and Chandler (forthcoming) examined whether the presence of ex-auditors working in a senior management role would have an influence on investors' perceptions of auditor independence in the UK. In contrast to previous findings, the results of the study indicated that the UK investors did not view the client's employment of a previous auditor as a threat to auditor independence. Further tests showed that institutional investors were less critical in their perceptions of the threats of auditor employment than were private investors. The study also examined investors' perceptions of what constituted a reasonable cooling-off period between an auditor leaving an audit firm and joining an audit client. They found that the majority of the respondents preferred a cooling-off period of no more than one year and concluded that further legislation on this issue may not be supported.

The following sub-section continues the discussion on ex-auditor's employment with audit clients based on studies that used the archival approach.

### **2.9.2 Studies using the Archival Approach**

While most prior studies used surveys or experimental approaches to test the perceived effect of ex-auditor's employment with an audit client, recent research in this area focuses more on the use of archival data. Menon and Williams (2004) examined the abnormal accruals for companies with and without former audit partners in 1998 and 1999 using

Jones' (1991) model. Based on multivariate analysis, they found that companies employing former audit partners as officers and directors reported larger accruals than companies that did not employ their auditors. These results indicated that earnings management is more common when officers are former partners of their audit firms and that affiliated audit firms are less likely to detect earnings management or more likely to waive companies earnings management efforts than non-affiliated audit firms. However, since Menon and Williams (2004) only examined a limited period of data, the results may not be extrapolated beyond the period they described.

Using a longer period of data, 11 years (1989-1999), Geiger et al. (2005) found conflicting results. They found no significant difference in the earnings management of companies that hired personnel from their audit firms and other types of control groups used in the study. They also found that changes in accruals surrounding the hiring of these individuals were relatively stable over the 11-year period studied. However, this study was uncertain as to whether the directors or officers working for the clients were previously the audit partners or managers who directly involved in auditing the clients' financial statements. Geiger et al. (2005) justified their selection using the findings in Imhoff (1978) to explain that, since the officers or directors were very senior at the audit firm before they left, a vast majority of them left their audit firms to join the client with whom they had previously worked as part of the audit engagement team. Menon and Williams (2004) however, did not recognise the problem of matching the ex-audit partners and their clients and for that reason, no justification was offered in their study.

Lennox (2005) examined the problem of ex-auditor's employment with an audit client and the propensity of an auditor issuing a GC opinion based on three different types of affiliations. First, an 'employment affiliation' occurred when the audit personnel were hired by the clients directly from their external auditors. Second, an 'alma mater affiliation' occurred when the ex-auditors convinced their current companies to appoint their former audit firms who currently did not audit the clients' financial statements. Finally, the 'chance affiliation' that occurred at random and with no identifiable causal

factors underlying the affiliation<sup>9</sup>. Based on multivariate tests on data from 1995 to 1998, the results confirmed the regulators' concern that an ex-auditor's employment with the client may impair audit quality. They found that audit firms were more likely to issue a clean opinion to companies with employment affiliations. Interestingly, they also found that, consistent with the results for employment affiliations, the alma mater affiliations also received clean opinions significantly more often than the chance affiliations, suggesting that the regulators should not only concern about the employment-affiliation, but also the alma-matter affiliations.

In discussing the findings in Lennox (2005), several limitations are noted. First, similar to prior studies in this area, this study might also experience an uncertainty in matching the former auditors with their audit clients to determine the employment affiliations. Secondly, they could not be sure that the alma-mater affiliation was due to the ability of the former auditors to persuade their current employers to change their current auditors to the former auditors' audit firms. Companies change their auditors due to many reasons and one of them is the resignation of the auditor. Finally, Lennox (2005) did not relate the possibilities of positive impacts from hiring auditors through employment affiliations. Companies may also receive more clean opinions due to the benefits of hiring former auditors who typically possess numerous attractive attributes such as vast experience in business strategy and financial reporting processes. Beasley et al. (2000, p. 35) stated that most employment relationships benefit the company and the ex-auditor "with no decline in the quality of financial reporting". Thus, the potential from hiring former auditors should be acknowledged in discussing the findings in Lennox (2005).

Another impact of ex-auditor's employment with the client can also be seen from the perspective of changes in audit fees. Basioudis (2007) posited that the placement of an audit firm's alumni into client management positions could lead to incoming auditors assessing lower levels of inherent audit risks and control risks which in turn resulting in lower audit efforts and the charging of lower audit fees. Using a sample of 1816 company

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<sup>9</sup> The 'chance affiliation' occurred at random when an ex-auditor who had never directly involved in the audit engagement of the client but subsequently left the audit firm to join the client (Lennox 2005).

directors who were also members of the ICAEW for 1996 and 1997, Basioudis utilised a regression model for audit fees to determine the effect of the association of having former auditors from their alma mater on audit fees. The results provided evidence that audit fees were significantly reduced for companies that hired former auditors from their external auditors (alma mater) to sit on their boards. When testing the time lapse impact, Basioudis also found that the audit fees discounts were larger when the ex-auditor had left the audit firm more recently. These findings presented more support for the imposition of rules that restrict auditors' immediate job transfers to their clients' companies and may be useful in strengthening the users' confidence in the independence of the auditor.

One of the limitations of the study is that, similar to Menon and Williams (2004), it only measured the changes in audit fees for a limited period (two years). The results might have been different had a longer period of data been tested. In addition, unlike prior archival studies in this area, Basioudis (2007) did not focus on the impact of former audit partners working on the clients' boards, instead he focused on the ex-auditor in general (who subsequently worked with the client) regardless of the prior positions held in the audit firm. The assumption of the study was perhaps that since the auditors are now working on the clients' boards, it should be assumed that they had the experience or were senior enough when they left their audit firms to make an impact on the audit firm's engagement risk and subsequently on audit fees.

### **2.9.3 Summary**

The literature of ex-auditors' employment with audit clients provides evidence that the practice is not uncommon in the accounting profession. It is found that auditor independence is perceived to be affected when an auditor is considering employment with the client or prior to joining the audit client. Prior evidence also suggests that the threat to auditor independence is greatest when the current auditor has to deal with a former audit partner of the engagement who is now working as a top manager or director for the audit client. Thus, the ex-auditor's prior supervisory position and the new position as an officer primarily in-charge of financial statements reporting for the clients have the potential to



impair the independence of the current or incumbent auditor. Finally, perceived auditor independence could also be influenced by a shorter time lapse between completing the audit and starting employment with an audit client.

The following section examines whether the existence of audit committees has the potential to enhance or impair auditor independence.

## **2.10 Audit Committees**

There is no precise or complete definition of an audit committee. The SOX 2002 (Section 2) defines audit committees as “a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer” (Beasley et al. 2009). Bedard and Gendron (2010) advocated that audit committees can improve the quality of information by overseeing the financial reporting process and indirectly through the oversight of internal control and external auditing.

It has been argued that auditor independence could be enhanced when an audit committee is involved in selecting external auditors, determining their remuneration and retention/dismissal of the auditors. Goldman and Barlev (1974) stated that the management power over the auditor would be limited if audit committees were established to deal with the selection of audit firms, the negotiation of fees and participating in matters involving an auditor’s replacement. Sori et al. (2009) also supported this argument, stating that the dilemma faced by the auditors, when management perform the role of approving and reviewing audit fees, would be reduced if audit committees were to undertake the roles. The findings in Beattie et al. (2013) provided further support for the argument as they found that audit committees that were primarily responsible for recommending the appointment and re-appointment of the auditors were perceived as enhancing audit quality. On the other hand, Mayhew and Pike (2004, p. 820) contended that “the board of directors’

audit committees may also have incentives to please management”, particularly when many companies have a CEO who is also the chairman of the board<sup>10</sup>.

Independence is often considered as an essential quality of audit committee members (Bedard and Gendron 2010). They are not associated with the company as employees or officers since the majority of audit committee members must consist of independent non-executive directors (MCCG 2007; Bursa Malaysia 2005). They could better recommend an external auditor and take on a more active role in overseeing the independence of the auditor and the effectiveness of the audit process. The Combined Code of Corporate Governance (CCCG) in the UK stated that if the board does not accept the audit committee’s recommendation, “it should include in the annual report and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation, and should set out reasons why the board has taken a different position” (CCCG 2008, C.3.6).

The Treadway Commission 1987 noted that having an audit committee is not enough; the committee must be informed, vigilant and proactive in order to perform effectively (Abbot and Parker 2000). The Blue Ribbon Committee (BRC) in the US further contended that independent directors in an audit committee are better able to evaluate the propriety of a management’s accounting, internal control and reporting practices (Abbot et al. 2004). In addition, in realising the complexity of the accounting and financial matter faced by the audit committee, the BRC recommendation also required that at least one of the committee members has accounting and related financial expertise, defined as “past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual’s financial sophistication, including being or having been a CEO or other senior officer with financial oversight responsibilities” (Carcello and Neal 2003, p. 98). A similar requirement has been

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<sup>10</sup> Mayhew and Pike (2004) investigated whether investor selection of external auditors enhances auditor independence. Using experimental design, they examined the effect on independence and independence violations when managers and investors hire and fire the auditors. Their analysis indicated that independence violations decrease when investors select the auditors.

subsequently incorporated in the listing requirement of the Bursa Malaysia in 2001 (Abdul Rahman 2006).

The effect of an audit committee on general perceptions of auditor independence has been investigated by many studies; most findings showing that the formation of an audit committee has a strong positive impact on auditor independence (Teoh and Lim 1996; Abu Bakar et al. 2005; Beattie et al. 1999; Alleyne et al. 2006; Sori et al. 2009). Interestingly, New Zealand's studies by Gul (1989) and by Cheung and Hay (2004) found that the presence of an audit committee was not a significant factor affecting bankers' and shareholders' perceptions of auditor independence. The other groups of respondents in Cheung and Hay (2004), the auditors and directors, perceived the existence of an audit committee as a safeguard to auditor independence. Gul (1989) suggested that the insignificant effect identified in his study may have been due to a lack of awareness on the role and importance of audit committee among New Zealand's bankers since, at the time of the study (20 years ago), relatively few companies had set up audit committees. Beattie et al. (1999) posited that perceptions regarding the influence of audit committees on auditor independence would appear to change drastically over time. The results from recent studies have shown that the existence of an audit committee was ranked highly as a factor that would enhance auditor independence in the UK (Beattie et al. 1999), Malaysia (Teoh and Lim 1996; Abu Bakar et al. 2005) Barbados (Alleyne et al. 2006) and Bahrain (Al-Ajmi and Saudagaran 2011).

However, only a very limited number of studies examine the perceptions of the *independent* audit committee as one of the factors that may enhance auditor independence. Beattie et al. (1999) found that the audit partners and finance directors in their UK study ranked the existence of an audit committee that was composed of non-executive directors, a majority of whom were independent, the highest. The result of this study is supported by Alleyne et al. (2006), Al-Ajmi and Saudagaran (2011). Sori et al. (2009) also found that the majority of Malaysian loan officers agreed with the view that auditor independence would be safeguarded if audit committees were mostly comprised independent and non-executive directors. Their result indicated an expectation that, as the majority of the audit

committees are independent of management interests, they would be able to effectively and efficiently monitor the management and enhance financial transparency. In the most recent study, Beattie et al. (2013) found that an audit committee that was composed of independent non-executive directors was perceived as significantly enhancing audit quality in the post-SOX 2002 environment.

Sori et al. (2009) examined the activeness of audit committees and whether, if audit committee reports were to be made in the annual report, it would enhance perceptions of auditor independence. The activeness of an audit committee was reflected by the frequency of the committee meetings. The authors expected that an active audit committee that spend more time in frequent meetings, to discuss issues relating to internal control, risk, financial reporting and other business matters, would improve auditor independence. They found that the majority of respondents regarded an active audit committee would better safeguard auditor independence. They also found a similar result if audit committee reports were to be made compulsory in the annual report.

In contrast to perceptual studies, prior archival studies provided much evidence suggesting that a more independent, expert and active audit committee is associated with higher quality financial reporting and auditing. Klein (2002) supported this claim, based on a sample of US firms in 1992 and 1993, and found that the presence of independent outside directors in an audit committee was associated with lower levels of unexpected or abnormal accruals. From the perspective of fraudulent financial reporting, Beasley et al. (2000) found that audit committees of fraud companies met less often than did the audit committees of companies without reported fraud.

In term of financial restatement incidents, Abbot et al. (2004) argued that an independent audit committee may demand greater external audit scope to avoid being associated with financial restatement, increasing the likelihood of the auditor detecting the misstatement. They examined the US data from 1991 to 1999, founding evidence that the frequency of accounting restatements was negatively associated with the audit committees' independence and activity (whether the audit committee met at least four times a year).

Abbot et al. (2004) also found a significant negative association between restatements and the presence of audit committees including at least one member with financial expertise, supporting the importance of having financial experts on an audit committee.

The presence of independent and active audit committees also encourages companies to hire a specialist auditor (Abbot and Parker 2000). Abbot and Parker (2000) believed that the net cost of litigation due to financial restatements would be higher for independent audit committees and that the use of an industry specialist auditor would provide a higher level of assurance to an independent audit committee than the use of a non-specialist auditor. Based on 1994 data and using three methods for identifying specialist auditors (mainly based on client's sales revenues within certain percentages) they found that firms with independent audit committees who met at least twice a year were more likely to use a specialist auditor.

There is also evidence that the presence of independent and active audit committees will prevent the formation of affiliation between an ex-auditor's former audit firm and his or her present company. Lennox and Park (2007) suggested that independent and active audit committees may perceive that officer-auditor affiliations represent a potential threat to audit quality and thus may not permit the formation of an affiliation. Even if they truly believe that there is no imminent threat, audit committees may still decline the appointment of the officer's former audit firm since they may have to explain why it was permitted should there occur a subsequent audit failure. Using US companies' data from 1995 to 2000, the regression results showed that companies were less likely to appoint an officer's former audit firm if an audit committee was more independent. However, the results also indicated that the number of meetings an audit committee holds during a year does not have a significant effect on the choice of audit firms.

In his historical analysis of corporate audit committee formation in the US, Birkett (1986) suggested that the audit committee was established primarily to safeguard the independence of the auditor. Knapp (1987) also supported this viewpoint when he discovered that an audit committee was more likely to support an auditor in disputes with

the management and thus strengthen the auditor's position and independence. Carcello and Neal (2003) provided evidence on whether or not an independent and expert audit committee could safeguard auditor independence by protecting the auditor from the potential dismissal subsequent to the issuance of GC audit reports. Based on a 12-year dataset from 1988 to 1999, they found that companies with a higher percentage of independent audit committees were less likely to dismiss their auditor following the issuance of a GC audit report. On the other hand, the study found no significant relation between audit committee members' financial expertise and auditor dismissal following GC opinions.

An independent audit committee could also help the auditor mitigate the pressure from the management to issue a clean audit opinion when a GC audit report is warranted. Carcello and Neal (2000) reported, based on a sample of financially distressed companies in 1994, that companies with a greater percentage of independent members on their audit committee were more likely to receive GC audit reports. Similarly, Md. Yusuf et al. (2002) also found evidence that an audit committee exclusively comprising outside directors was more supportive to auditors in issuing GC opinions. Md. Yusuf et al. (2002) used similar sample characteristics to Carcello and Neal (2000) but based on companies listed on Bursa Malaysia.

## **2.10 Summary**

Prior perceptual studies have shown that the existence of an audit committee was perceived as enhancing auditor independence. It was also evident that an audit committee plays a significant role in the appointment of an auditor, determining an auditor's remuneration and re-appointment or the dismissal of an auditor. Prior archival studies also provided more evidence regarding the imperative that audit committees be independent, active and in possession of financial expertise, in order to be effective in performing their roles and to promote better audit quality.

However, it is observed that prior perceptual studies only examined audit committees in general. A very limited number of studies has examined whether auditors or financial statement users perceive an active or inactive audit committee, an audit committee with or without financial expertise and the requirement for a compulsory audit committee report to be disclosed in the annual report as enhancing or impairing auditor independence. Since the regulators now require that an audit committee must be independent in majority, active in the frequency of its meetings and possessing at least one member with financial expertise, the breach of such requirements may be viewed as factors potentially leading to independence impairment. Thus, it is the intention of the current study to investigate the perceived impact of the roles and characteristics of audit committees on auditor independence in a more comprehensive way, a way in which prior studies have failed in their investigations.

## **2.11 Other Factors Influencing Perceptions of Auditor Independence**

The primary focus of this research is on the relationship between the five factors previously reviewed and perceptions of auditor independence. However, there are other factors that may influence respondents' perceptions and attitudes towards this issue. In ethical decision making studies, influences on individual perceptions can be categorised in two broad categories: situational factors and individual factors (Ford and Richardson 1994). Situational factors include respondents' referent group (e.g. peer group and top management influence), organisational culture, industry norms and overall social values. Individual factors include level of education, prior working experience, gender, age and values. Factors such as accounting qualifications, prior experience as an auditor or accountant in the industry, gender and age, have been identified in prior studies as among the factors with the potential to influence independence perceptions. Due to this reason, the following sub-sections will review these factors.

### **2.11.1 Accounting Qualifications**

Several critics of independence studies have made reference to prior research suggesting that the more knowledgeable respondents are about the profession and auditing, the more likely they are to perceive auditors to be independent (Burton 1980; Mednick 1990). Pany and Reckers (1983) also argued that respondents who do not understand the functions of auditing would indicate the greatest fear that auditor independence would be impaired when NAS are also provided to audit client. However, their examination of respondents' backgrounds such as their formal training in accounting and their possession of basic auditing knowledge, revealed no significant impact on directors' perceptions of auditor independence. In their subsequent study, Pany and Reckers (1984) used a variable called 'respondent knowledge' to measure respondents' knowledge of the audit function. The results also failed to support the argument that those with low awareness of audit functions are those most concerned about auditor independence.

In another study, Bartlett (1993) measured accounting qualification using the number of college-level or work-related courses taken in accounting topics. Its impact on auditor independence was tested and the overall finding was consistent with Pany and Reckers (1983, 1984), for it was found that the level of accounting knowledge did not affect perceptions of independence. Dart (2011) compared perceptions of auditor independence between institutional investors and private investors. Echoing prior results, Dart (2011) found that accounting knowledge did not affect institutional investors' perceptions of auditor independence. However, the results showed that private investors without accounting qualifications were more concerned than those with qualifications about the threats of long tenure and economic dependence. Similarly, a recent study by Dart and Chandler (forthcoming) found that accounting qualifications did affect private investors' level of concern regarding a client's employment of an ex-auditor.

Since there is limited recent research that has examined the impact of knowledge of accounting and auditing on independence perceptions, and that the recent results indicated that there is evidence to support the argument that those without accounting qualifications



would be more concerned about auditor independence, the current study intends to further examine this issue using data from an emerging market.

### **2.11.2 Prior experience in accounting firms or as an accountant in industry**

Firth (1980) argued that respondents who have previously worked as auditors or accountants in industry and commerce may be less concerned about auditor independence and that their perceptions may be closely associated with the auditor's or financial statement preparers' perceptions. Accountants working in industry normally have prior training with professional accounting firms and their perceptions may be consistent with the auditor's perceptions. They may also have an interest in minimising audit fees and in maintaining a good relationship with their auditors which others may regard as independence impairing. Firth (1980) examined this notion and found that respondents' prior experience in industry as auditors or accountants has no significant impact on their perceptions of auditor independence. In a recent study, Dart and Chandler (forthcoming) also found that respondents' perceptions of auditors' employment with audit clients were not affected by whether or not they had prior experience of moving from an audit firm to an audit client.

Based on the above argument, the current study aims to provide more recent evidence regarding the impact of prior experience on perceptions of auditor independence. It can be expected that if the respondents in the current study have prior experience as auditors or accountants in industry, they would perceive auditor independence issues differently from those without the experience.

### **2.11.3 Age**

Prior studies in business ethics research suggested that respondents' age had the potential to influence ethical beliefs and behaviours. Serwinek (1992, p. 565) stated that "age is the most influential demographic predictor of ethical standards ..... unless age is considered in design, the experimental results obtained will probably be misleading". Peterson et al.

(2001), who examined business professionals, and Deshpande (1997), who examined middle-level managers, reported that ethical awareness increases with age of respondents in their studies. Similarly, Ruegger and King (1992), who studied business students' perceptions and Serwinek (1992), who studied employees in small businesses, identified age as a significant factor in their research into ethical behaviour. All these findings suggested that, as respondents grow older, they tend to become more conservative in their ethical perspectives. However, in studying internal auditors' ability to identify ethical dilemmas, Larkin (2000) found that age to have no significant influence. Consistently, Firth (1980) reported that age did not account for differences in various groups of respondents' perceptions of auditor independence and official ethical guidelines.

Based on the above suggestion, the effect of age for the current study could be that older respondents may be more concerned than younger respondents about the potential of factors such as long audit tenure and NAS to impair independence.

#### **2.11.4 Gender**

According to social role theory (Eagly 1987, p. 309, cited in Franke et al. 1997), women are seen as more understanding, "friendly, unselfish, concerned with others, and emotionally expressive" while men are more "independent, masterful, assertive and instrumentally competent". The social role theory also states that men may focus more than women on monetary evidence of business success and they also appear more likely to recognise ethical problems involving money such as cash bribes and non-cash gifts (Franke et al. 1997). However, the findings in many business ethics studies seemed to contradict this social role theory. Deshpande (1997) and Peterson et al. (2001) found that female respondents showed a higher level of ethical beliefs than did their male respondents. Likewise, Ruegger and King (1992, p. 179) found that "gender is a significant factor in the determination of ethical conduct and that females are more ethical than males in their perceptions of business ethical situations". Similarly, in his research on internal auditors' ability to indentify ethical dilemmas, Larkin (2000) found evidence that suggested female auditors were better able to identify ethical problems than their male counterparts. On the

other hand, Serwinek (1992) found that gender failed to be a reliable predictor of ethical behaviour.

There are many studies related to public accounting that focus on gender differences and the results have been inconclusive (see Trapp et al. 1989, Iyer and Raghunandan 2002, Iyer et al. 2005). However, only a small selection of studies have investigated and reported whether or not gender differences exist in auditor independence perceptions. Iyer and Raghunandan (2002) examined the perceptions of CPA firm alumni about their ability to resolve disagreements with auditors who happen to be their former employers. Based on regression analysis, the results showed that male alumni were more likely to indicate that they could resolve disagreements more easily than their female counterparts. On the other hand, the regression analysis in Dart and Chandler (forthcoming) indicated that gender had no impact on the UK investors' perceptions of auditor independence. Their findings provided support for another UK study by Dart (2011). In a study of auditors' independence judgment under pressure, Umar and Anandarajan (2004) found that the gender factor has little influence on auditors' perceptions of independence when faced with pressure on the job.

Since the findings in prior studies on the impact of gender on perceptions of independence seemed conflicting, the current study intends to further examine this issue. It can be expected that female respondents will be more worried about the threats to auditor independence due to their caring personality, whereas male respondents may be less worried since they are more concerned about monetary evidence of independence impairment.

#### **2.11.5 Summary**

There are many factors that may influence respondents' perceptions. In this study, such factors as accounting education, prior experience as auditors or accountants in industry, gender and age have been reviewed and they will be further tested in determining whether they have the potential to influence independence perceptions. Even though prior studies

indicated that accounting knowledge and prior experience as auditors or accountants have no influence on independence perceptions, these studies are limited and mostly dated. Thus, the current study intends to provide recent evidence by re-examining these issues. The present study will also be looking at age and gender differences in the perceptions of auditor independence and it is hoped that results will add to the general literature about the differences surrounding this issue.

## **2.12 Chapter Summary**

The main purpose of this chapter is to provide an overview of the previous literature in the area of auditor independence. The definition of auditor independence is provided even though prior studies indicated that the concept is difficult to define and will change over time. The concept of agency theory and how it relates to auditor independence issues are also discussed in this chapter. In addition, this chapter highlights other models of auditor-client relationship since they are widely cited elsewhere, particularly the economic models, in the research area of auditor independence.

The factors having potential impairment on auditor independence have been reviewed based on behavioural and archival studies, namely: long audit tenure, fee dependence on a single client, the provision of NAS to audit clients, ex-auditor's employment with audit clients and the existence of audit committees. All of these factors have been highlighted in the review of the literature particularly in the light of recent concerns regarding the perception of auditor independence among members of the public.

The literature review also revealed that provision of NAS to audit clients has been extensively researched, followed by the subjects of long audit tenure and audit committees. Conversely, the empirical evidence regarding fee dependence on a single audit client and ex-auditor employment is still limited. The literature review also indicated that, except for audit committees, the findings surrounding the impact of the other four factors on auditor independence are not consistent. The conflicting nature of these research findings could be due to the various and varied research designs used such as experimental designs,

questionnaire surveys and archival methods which mostly used published secondary data. The perspectives of several different subject groups were also examined. These included bank loan officers, financial analysts, company managers and directors, private investors, financial and business journalists and auditors. As part of this literature review, the limitations of prior studies have been highlighted, providing gaps that the current study intends to fill.

Finally, other factors potentially capable of affecting respondents' perceptions of auditor independence were also discussed. These included accounting knowledge, prior experience as auditors or accountants in industry, age and gender.

The following chapter will present an overview of the auditing profession and financial reporting environment in Malaysia.

## **CHAPTER 3 - AUDITING BACKGROUND AND THE FINANCIAL REPORTING ENVIRONMENT IN MALAYSIA**

### **3.1 Introduction**

In Chapter 2, a review of the literature in the area of auditor independence has highlighted five factors as having the potential to affect perceptions of auditor independence, namely: long audit tenure, auditors' financial dependence on a single client, NAS, ex-auditors' employment with audit clients and the existence of an audit committee. This study intends to examine the perceptions of Malaysian loan officers and professional investors concerning these five issues. This chapter aims to provide background information regarding Malaysia in general and the Malaysian auditing and financial reporting environment in particular. Understanding the social, economic and institutional background of the country is important as it provides a greater understanding of the issues under study.

This chapter is divided into eight sections. Section 3.2 describes the social and economic background of Malaysia. This is followed by Section 3.3 which explains the occurrence of the Asian financial crisis in 1997 and the steps taken by the government to overcome the problems that arose during that crisis. Next, Section 3.4 discusses the accounting profession and the financial reporting environment. In this section, key players in the accounting and auditing profession and their roles in the financial reporting process are described in detail. This is followed by Section 3.5 which provides a discussion of CA firms in Malaysia. Next, Section 3.6 presents the development and characteristics of the audit committee in Malaysian public listed companies. The most recent initiative of the Malaysian government in promoting good corporate governance has been the establishment of the Audit Oversight Board (AOB) and this initiative is explained in Section 3.7. Finally, Section 3.8 provides a summary and conclusion of this chapter.

### 3.2 The Social and Economic Background of Malaysia

To provide an understanding of the accounting and auditing background in Malaysia, it is important to have an overview of the Malaysian social and economic history as this has had a profound impact on accounting and auditing practices. Malaysia consists of various races, religions, creeds, customs and languages, which have come into being over the last 150 years. The races can be divided into two main groups; *bumiputra* (sons of the soils) and non-*bumiputra*. The *bumiputra* comprises the Malays and the indigenous people, while the non-*bumiputra* comprises the Chinese, Indians and other minority ethnic groups.<sup>11</sup> Two main ethnic groups, the Malays and Chinese, play a role in much of the socio-economic and political environment of the country. The Malays are said to control the political administration while the Chinese have heavily influenced the economic environment.

Malaysia achieved her independence from British colonialism in 1957. One of the negotiations in the transfer of power between the British and the nation's political leaders from the Malay, Chinese and Indian communities was the continuance of the existing free enterprise economic policy including the non-nationalisation of British-owned companies. As a result, the immediate post-independence government almost mirrored the British colonial administration.

Racial tension due to unbalanced business and economic activities in Malaysia led to racial violence between the Malays and Chinese in May 1969. The government declared a state of emergency and suspended all parliamentary activities. In the years that followed, Malaysia undertook several initiatives to improve its social and economic conditions. The New Economic Policy (NEP) was launched in 1971 with two main objectives; to eradicate poverty irrespective of race and to restructure Malaysian society by eliminating the identification of race with economic function (Jomo 1990).

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<sup>11</sup> In 2009, Malaysia has a total population of 28.3 million with 14.4 millions males and 13.9 millions females (Malaysia 2009). The *bumiputra* represents about 62% of the population. This is followed by the Chinese at 23%, the Indians at 7% and other minority ethnic groups make up the remaining 8% of the population.

One of the key targets of the NEP was related to the area of employment which should be reflective of the ethnic composition of the total population at large. Another key target of the NEP involved the restructuring of the ownership of capital which aimed to increase the share of *bumiputras*' capital as well as the number of *bumiputra* businessmen and professionals. This effort subsequently changed the pattern of capital from European-Chinese to Chinese-Malay and from private ownership to ownership by the state and quasi-public bodies (Sieh 1982, cited in Ali 2006). It was reported that within a period of seven years after the launch of the NEP, the state had taken ownership and control of almost all of the large plantations (such as Sime Darby, Guthrie, Boustead and Highlands and Lowlands) and held a 40% stake in each of the three largest domestic banks in Malaysia (Ali 2006). The government ownership of the local banking industry increased to 77% and 50% of the total banking industry by 1980. This signified that the government had direct control over institutional credit which also indicated that it had influence not only over its enterprises but also over the rest of the business community.

However, in the early 1980s the government realised that purely state-owned enterprises were not the best method for achieving rapid growth and social goals. The economic recession in the mid 1980s forced the government to loosen its economic restrictions in order to promote economic growth (Che Ahmad et al. 2006). As a result, many foreign capitalists mainly from Japan, the US, Taiwan and Singapore, came to invest in Malaysia. During this time, the government authorities aggressively promoted the Bursa Malaysia (previously known as the Kuala Lumpur Stock Exchange) by increasing foreign shareholdings of local brokerage firms from 30% to 49%. Taxes for both local and foreign fund managers were reduced from 30% to 10% and the participation of institutional investors was encouraged (Sharma 2003). In addition, a new law was issued in 1989 governing the banking and financial institutions by empowering supervisory authorities with broad regulatory, intervention and enforcement. The country's central bank, Bank Negara Malaysia (BNM) also followed active policies in addressing such concerns as tighter rules regarding loan classification, provisioning and disclosure requirements, capital adequacy and bank liquidity (Sharma 2003).



The following section will briefly discuss the Asian financial crisis of 1997 and the steps that were taken by the government to overcome the problems that arose due to that crisis.

### **3.3 The Asian Financial Crisis**

Throughout decade before the Asian financial crisis hit the country in 1997, the Malaysian economy was booming. Malaysia was regarded as one of the East Asian Tiger economies, characterised by sustained high economic growth and a substantial level of investment. Malaysia's GDP growth averaged 8.9% in the period between 1990 and 1995, and 8.6% and 7.7% in 1996 and 1997 respectively (Sharma 2003). The period also witnessed virtually full employment in the Malaysian economy with modest inflation and with a succession of budget surpluses that helped lower public debt, boost savings and encourage private-sector growth (Sharma 2003). In addition, throughout the 1990s, the average growth rate among of listed companies was 10% (Khatri et al. 2002). The average annual growth of the total market capitalisation of companies listed on the main and second boards of the Bursa Malaysia was 40% which was mainly driven by increasing share prices, a high level of new equity issues and privatisations (Liew, 2007).

Nevertheless, in mid-1997, the Thai currency crisis caused the worst financial and economic crisis in the East Asian countries. Each country experienced severe erosion in investor confidence and massive capital outflows, resulting in sharp declines in reserves, stock market collapses and currency depreciation. Malaysia was the country most severely affected as within the six months between July 1997 and January 1998, the Malaysian Ringgit depreciated by almost 50% and interest rates increased to more than 12% per annum (Abdul Rahman 2006)<sup>12</sup>. As a result, the Malaysian stock market collapsed, losing over 65% of its capitalisation and wiping almost RM225 billion off share values. The composite index dropped from over 1300 points in the first quarter of 1997 to merely 262

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<sup>12</sup> In July 1997, the Ringgit was trading at RM2.50 to USD1.00 but it dropped to its lowest level of RM4.88 to the dollar in January 1998.

points in September 1998. In addition, the Malaysian economy registered a negative growth rate of 6.5% in 1998, a very sharp decline from the rate experienced before the financial crisis (Sharma 2003).

Weaknesses in the banking systems were predominantly blamed for the crisis (Thomas 2002; Thillainathan 1999). The rapid expansion of credit, over-exposure of the banking system to the volatile property and share markets, weak management and supervision as well as the failure of the authorities to improve Malaysian banking standards towards international best practices have been cited as the causes of the banking crisis (Thomas 2002). The rise in equity prices before 1997 had contributed to a substantial increase in domestic lending, leaving Malaysia with a high proportion of domestic debt to GDP (170%), among the highest in the world (Kaplan and Rodrik 2002). A large proportion of such debt was corporate debt, principally borrowings by listed companies and short-term borrowings to fund long-term projects (Thomas 2002). With the increase in interest rates and the economic contraction, the inability of these companies to meet their debts created a large number of non-performing loans for the banking sectors and subsequently aggravated the financial crisis.

The other major factor that has repeatedly been cited as one of the causes of the financial crisis was poor or ineffective corporate governance practices in listed companies, identified as leading to these ill-advised investment decisions (Thomas 2002; Liew 2007). Abdul Rahman (2006) highlighted several examples of weaknesses in the corporate governance mechanism that resulted in countries such as Malaysia being highly susceptible to the financial crisis. They include:

- Weak financial structure of many companies
- Over-leveraging by companies
- Lack of transparency, disclosure and accountability particularly inadequate disclosure of risk exposures
- Existence of a complex system of family-controlled companies

- Absence of effective laws to ensure that controlling shareholders and management treat small investors fairly and equitably
- Assets shifting
- Conglomerate structures that were perceived to be given preferential treatment
- Allegations of cronyism.

In the aftermath of the outbreak, several macroeconomic measures were taken by the government to stabilise the economy. The government's initial responses to the crisis were considered as the orthodox approach that involved increasing interest rates to stem the decline of the Ringgit and announcing a drastic cut in government spending (Kaplan and Rodrik 2002; Sharma 2003). The Malaysian economy, however, failed to respond to these orthodox actions as consumption and investment demand plunged as a result of capital outflows, high interest rates and the pessimistic outlook.

In January 1998, the establishment of the National Economic Action Council (NEAC) was announced as a consultative body to the Cabinet to deal with the crisis. The NEAC's primary task was to prepare the National Economic Recovery Plan (NERP) which presented a comprehensive framework for action for national economic recovery. The objectives of the recovery plan were to stabilise the Ringgit, restore market confidence, maintain financial market stability, strengthen economic fundamentals, continue with the equity and socio-economic agenda, and revive adversely affected sectors (NEAC 1998). To deal with the rising non-performing loans in the banking system, the government established Danaharta in June 1998, an asset management and recovery agency designed to acquire non-performing loans from financial institutions at fair market value and to maximise their recovery value (Zainal Abidin 1999). Local legislation vested Danaharta with special powers over borrowers, helping ensure that banks were left with a manageable share of problem loans and that non-performing loans were dealt with promptly.

In July 1998, Danamodal was established to manage bank restructuring and recapitalisation. Working in parallel with the removals of non-performing loans by Danaharta, Danamodal provided fresh capital for financial institutions to increase the capital adequacy ratio by raising RM3 billion in paid-up capital from the BNM and RM7.7 billion through the issuance of bonds to financial institutions. To ensure that banks were managed prudently and efficiently after such capital injections, Danamodal exercised control over management by appointing at least two members to the board of directors, one of whom had to be an executive director or chairman of the board (Sharma 2003).

In July 1998 also, the government established the Corporate Debt Restructuring Committee (CDRC) that served to facilitate the restructuring of large corporate debts by providing a platform for discussions between borrowers and financial institutions to workout feasible restructuring schemes without having to resort to legal proceedings. While Danaharta, Danamodal and CDRC were governed by their respective operational frameworks, their roles were complementary. All these entities were coordinated by a Steering Committee chaired by the Governor of the Central Bank of Malaysia.

In September 1998, the government imposed controls on capital outflows and restrictions on exchange rate transactions in an effort to immediately eliminate the offshore market for the Ringgit, protect the remaining exchange reserves and regain monetary independence (Sharma 2003)<sup>13</sup>. The authorities also imposed tight limits on transfers of capital abroad by residents. Malaysian citizens were allowed to take only as much as RM1,000 (about USD250) out of the country while non-citizens were prohibited to take out more than RM10,000 although they could bring in an unlimited amount of foreign currency. Even though the capital controls approach was unpopular among the local and international business community, it was found to be effective in achieving the immediate goal of closing the offshore market (Sharma 2003).

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<sup>13</sup> The exchange rate was fixed at RM3.80 to USD1.00, a rate that represented a 10% appreciation relative to the level that the Ringgit had been trading at.

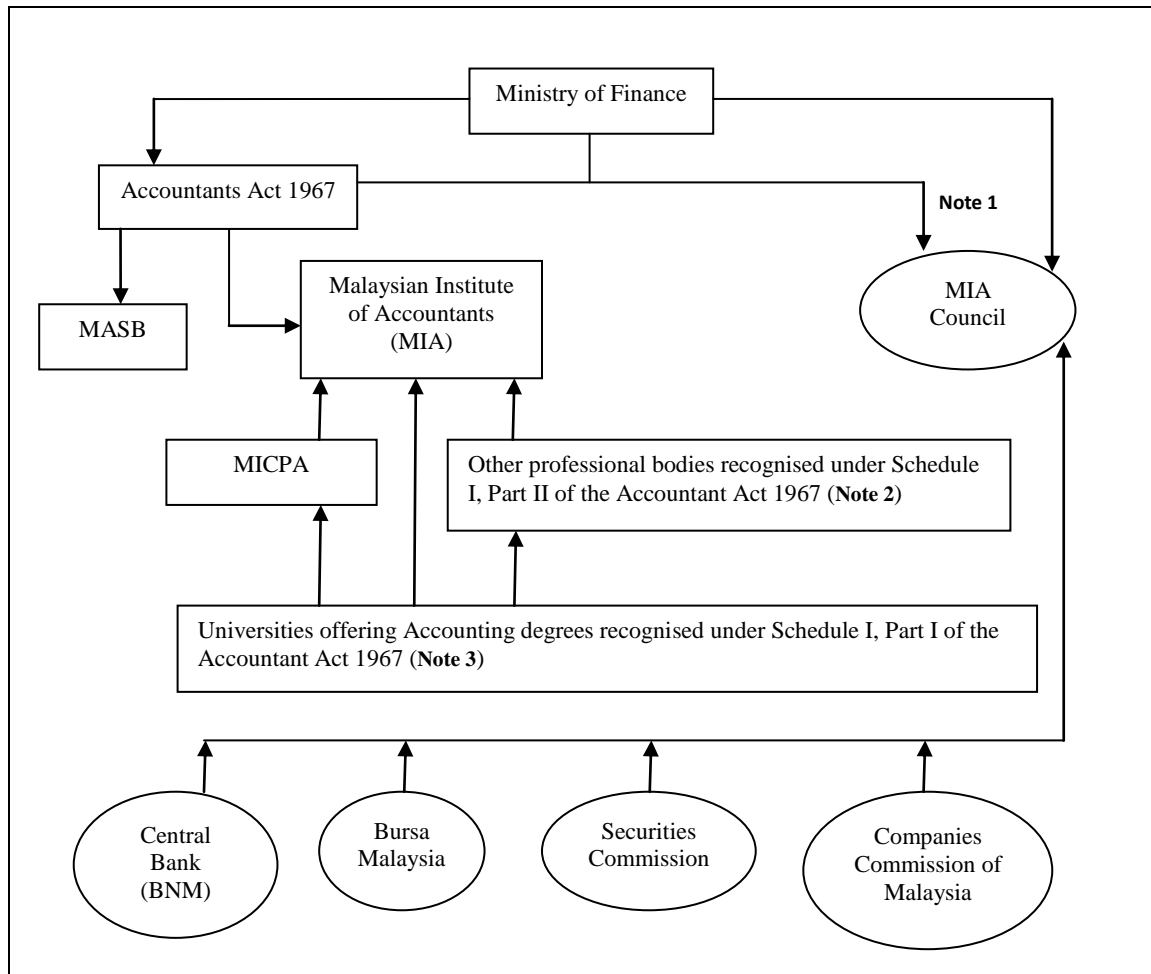
In short, the recovery policies undertaken by the government under the NERP achieved positive results. The measures resulted in economic recovery with GDP growing at an average rate of 7.2% during 1999 to 2000 (Mokhtar et al. 2009). Kaplan and Rodrik (2002) commented that the policies undertaken by the Malaysian government produced faster economic recovery, smaller declines in employment and real wages and more rapid turnaround in the stock market as compared to other neighbouring countries which undertook the International Monetary Fund (IMF) programs or assistance. Signs of Malaysia's remarkable recovery from the crisis were also evident with growths in GDP at above 4% in 2002 and 2003, alongside the IMF's and World Bank's forecast GDP growth of between 5 and 5.5% in 2004 respectively (Fadzly and Ahmad 2004).

In the next section, the accounting profession and the financial reporting environment in Malaysia will be discussed.

### **3.4 The Accounting Profession and the Financial Reporting Environment in Malaysia**

The financial crisis revealed that the existence of a strong accounting profession is crucial to ensure investors' confidence in a capital market system. The audit requirement provides credibility in the financial statements prepared by the management of companies that will be used by various stakeholders of the companies. However, the responsibility for ensuring that proper accounting and auditing procedures have been followed does not rest solely on the shoulder of the accounting profession. Regulators such as the Securities Commission (SC), the Companies Commission of Malaysia (CCM), the Central Bank as well as the corporate players, directors and the management of the companies, also play important roles in ensuring that proper financial reporting is in place and in protecting the public interest. Figure 3.1 shows the various legislations that directly impact the accounting regulatory process as well as the related institutions that were established to regulate the process.

**Figure 3.1: Regulatory Framework of the Accounting Profession in Malaysia**



**Note 1** - The Accountant General represents the government in the MIA Council

**Note 2** - Included in the First Schedule Part I, other than the MICPA, are the Association of Chartered Certified Accountants (ACCA), CPA (Australia), the Chartered Institute of Management Accountants (CIMA) and the Institutes of Chartered Accountants of Australia, Canada, England and Wales, India, Ireland and Scotland.

**Note 3** - Graduates from recognised local universities with 3 years relevant work experience can become members of the MIA directly and become known as Chartered Accountants.

Source: (Arens et al. 2006)

The Accountants Act 1967 was set up to deal with the regulation of the accounting profession. In 2002, it was amended to reflect the regulatory function of the MIA. As can be seen from Figure 3.1, the relationship between the government and the Institute is represented by the Accountant General as one of the members of the MIA Council. The amended Act also enlarged the membership of the Council from 15 members to 30. The members represent the stakeholders in the accounting profession which includes

representatives from other professional accounting bodies, recognised local universities, the BNM, Bursa Malaysia, the SC and the CCM. The composition of the Council members signifies the shared responsibilities of these organisations in the regulation of the accounting profession throughout the country. The following sub-sections will discuss the roles of each of the organisations involved in the country's financial reporting environment.

#### **3.4.1 The Malaysian Institute of Certified Public Accountants (MICPA)**

The MICPA is the earliest accountancy body in Malaysia. It was established in July 1958 as the 'The Malayan Association of Certified Public Accountants' under the Companies Ordinances 1940-1946. The name of the association was changed to the 'The Malaysian Association of Certified Public Accountants (MACPA)' in 1964 and subsequently the MICPA in January 2002. The MACPA was set up as a company limited by guarantee with the objective of advancing the status and development of the accounting profession in Malaysia. Prior to the formation of the Malaysian Accounting Standards Board (MASB) and the MIA, the MICPA was entrusted with the responsibility for issuing accounting rules, standards and pronouncements (Ku Ismail 2003). In 1978, the body adopted the International Accounting Standards (IASs) and issued its own standards when the IASs were not appropriate to the Malaysia financial reporting environment or when the IASs did not cover certain issues. At present, the MICPA remains the only local body in Malaysia that conducts professional accountancy examinations, a privilege which is recognised under the Accountants Act 1967. The examination procedure was designed with assistance from the Overseas Accountancy Examination Advisory Board of the ICAEW.

#### **3.4.2 The Malaysian Institute of Accountants (MIA)**

The MIA was established in 1967 under the Accountants Act 1967 to regulate and develop the accounting profession in Malaysia. It remained in a latent state in the first two decades of its existence and limited its role to registering accountants in the country (Ali 2006). In 1987, the MIA was made active by the government for two primary reasons: to increase

the number of local accountants and to control the accounting profession from the “undesirable elements”<sup>14</sup> (Ali 2004a, p. 10).

The main functions of the MIA are as follows (Arens et al. 2006):

a) Establishing Standards and Rules

The MIA is responsible to set auditing standards and rules to which all members must comply. The Accounting and Auditing Committee of the Institute issues pronouncements, guidelines and interpretations of the auditing standards, Recommended Practice Guides and technical bulletins. The auditing standards issued by the MIA are called the Malaysian Approved Standards on Auditing (MASA). There are two types of MASA:

- Standards adapted and adopted from the International Standards of Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB) of the IFAC.
- Standards issued by the MIA to supplement the ISAs, which are called Malaysian Standards on Auditing (MSA). These standards are intended to deal with topics not covered by the ISAs where special features of the Malaysian environment warrant domestic standards written specifically to address the local features.

The MIA actively participates in the accounting standards-setting process although the issuance of the standards is the responsibility of the MASB. The Institute also issues Recommended Practice Guides, which constitute part of approved accounting standards in Malaysia. Apart from that, the MIA issues guidelines on

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<sup>14</sup> The number of unqualified accountants grew during the economic expansion between 1970s and early 1980s. This situation caused the government to incur millions Ringgits of losses due to the falsification of client's accounts by unqualified auditors, resulting in a loss of confidence in the profession among the general public and foreign investors (Ali 2004a).



internal auditing, Malaysian Management Accounting Guidelines, Insolvency Guidance Notes and Insolvency Suggested Checklists. The Institute also issues By-Laws (on Professional Conduct and Ethics) which contain rules of conduct and ethics that all members are required to comply.

b) Financial Statements Review

The Financial Statements Review committee of the MIA regularly reviews financial statements (including director's reports, auditor's reports and any such statements) that are prepared by or under the responsibility of members of the MIA. The purpose of this function is to determine the members' compliance with relevant statutory requirements, approved accounting standards and the MASA.

c) Investigation and Disciplinary

The investigation and disciplinary committees of the MIA are formed with the primary objective of looking into formal complaints against its members and cases of unprofessional conduct and unethical practices alleged to have been committed by its members. The Institute also commences investigations following referrals by authorities, usually the SC. A formal complaint against an MIA member goes to the Investigation Committee, which will determine whether there are sufficient grounds for disciplinary proceedings to be taken against the relevant accountant. Without a formal complaint, the MIA could not initiate investigations for fear that members could sue the Institute on the basis that the legal framework does not support such a course of action (Zaimee 2007). If there is enough reason to support a complaint, the Disciplinary Committee will hold a hearing and impose punishments if the member is found guilty of unprofessional conduct.

d) MIA Practice Review

Practice review is a process in which the activities of a practising accountant are reviewed by another qualified member within the profession (MIA 2002). The MIA Practice Review program was implemented in 2003 with three basic objectives:

- To confirm that members comply with the standards set by the Institute
- To undertake the regulatory role as provided under the Accountants Act 1967 as well as to be aligned with the recent international development
- To enhance the confidence of the business community in the members' standard of professional work.

The practice review program is intended to ensure all audit firms registered with the MIA operate at least to the required minimum standards. The program is also intended to be educational and to help MIA members working in public practice to improve their professional standards where necessary. Essentially, the review exercise involves, among other things, a review of current audit engagement files and related financial statements. Where a member is found to be not following professional standards in certain situations, suggestions and recommendations may be made, which may be followed by a further review. The Practice Review Committee of the MIA determines the detailed practice and procedures to be observed in relation to practice review.

Apart from the above functions, the MIA is also an active member of regional and international professional bodies. The MIA plays a significant role in developing and advancing the accounting profession through its involvement in organisations such as:

- The Asean Federation of Accountants
- The Confederation of Asian and Pacific Accountants
- The IFAC.

The involvement of the MIA in these accounting bodies enables Malaysian Accountants to have a voice on these regional and international platforms and also enables the latest developments to be brought home for the betterment of the local accountants.

To date, the MIA has more than 27,000 members. Its membership can be divided into 4 categories:

- 1) Chartered Accountants in Practice
- 2) Chartered Accountants Not in Practice
- 3) Associate Members
- 4) Licensed Accountants.

To qualify as chartered accountants, candidates must pass the final examinations of the degree as specified in Part I of the First Schedule of the Accountants Act 1967, or be members of any of the recognised bodies specified in Part II of the First Schedule, and have not less than three years practical experience in the service of a chartered accountant or in a government department, bank or other organisation approved by the MIA Council. Most chartered accountants are not in currently practice but can be found in the industrial, commercial and the public sectors.

As for licensed accountants, candidates should satisfy the Council that they are members of the Malaysian Society of Accountants and that they have passed the final examination of that body and have not less than three years' practical accounting experience in the service that is similar to the requirements for chartered accountants. Finally, candidates for associate membership must have a minimum of three years of teaching experience in accounting-related subjects at an institution of higher learning with a degree and masters degree qualification, one of which must be majoring in accounting.

As members of the MIA, accountants are required to continuously update their knowledge and professional competency over time. It is also a requirement of the MIA By-Laws that members should enhance their professional competence and comply with the Continuing Professional Education (CPE) guidelines as prescribed by the Council. An annual CPE audit is carried out by the MIA to ensure that members comply with the CPE requirements. The minimum requirement of the CPE must be met, otherwise accountants will be subjected to disciplinary action.

### **3.4.3 The Malaysian Accounting Standards Board (MASB)**

The MASB was established in mid-1997 under the Financial Reporting Act 1997 as an independent authority to develop and issue accounting and financial reporting standards in Malaysia that was previously under the responsibility of the MIA and MICPA. The financial arrangements for the operations of the MASB are provided by the Financial Reporting Foundation, a trustee body that is also responsible for the oversight of the MASB's performance. The main functions of MASB are to:

- Issue new accounting standards as approved accounting standards
- Review, revise or adopt the existing accounting standards as approved accounting standards
- Issue statements of principles for financial reporting
- Sponsor or undertake the development of possible new accounting standards
- Conduct such public consultations as may be necessary in order to determine the content of accounting concepts, principles and standards
- Develop a conceptual framework for the purpose of evaluating proposed accounting standards
- Make such changes to the form and content of proposed accounting standards as is considered necessary.

According to Section 166A of the Companies Act 1965, the financial statements of commercial, industrial or business enterprises in Malaysia and of overseas subsidiaries and associated corporations where those accounts are to be incorporated in consolidated accounts in Malaysia must be prepared in accordance with approved accounting standards. In this case, the approved accounting standards include the MASB standards issued and the IASs and Malaysian Accounting Standards (MASs) adopted. The MASB initially adopted 24 of the extant IASs and MASs issued by the Malaysian professional accountancy bodies prior to the establishment of the MASB. Adoption by the MASB gave these IASs and MASs the status of approved accounting standards until each of these standards is amended, deleted or replaced by a new MASB standard.

As mentioned earlier, the MIA and other professional accounting bodies provide input to the MASB at every phase of the standards settings. The standards are developed in accordance with the principles, objectives, and concepts laid down in the MASB's A Proposed Framework for the Preparation and Presentation of Financial Statements. The MASB standards are also developed with reference to the work of other national standards setter such as Australia, the UK, New Zealand, Canada, the US and the International Accounting Standards Committee (IASC). As a result, the MASB standards are generally consistent with the present international practice.

In 2005, all MASB standards were renamed as Financial Reporting Standards (FRSs) in an effort to align the local accounting standards with the International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB). The standards were also renumbered, a process coinciding with the numbering of IFRSs. On 1<sup>st</sup> January 2006, all Malaysian companies were required to implement all the FRSs issued by the MASB in their preparation and presentation of financial statements<sup>15</sup>. In August 2008, the MASB announced their plans to bring Malaysia into full convergence with IFRSs by 1<sup>st</sup> January 2012.

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<sup>15</sup> All companies are required to comply with the FRSs issued by the MASB except for private entities. The private entities will continue to use Private Entity Reporting Standards until such time the MASB decides otherwise.

#### **3.4.4 The Central Bank – Bank Negara Malaysia (BNM)**

The BNM was established in 1959 under the Central Bank of Malaya Ordinance 1958. It is a regulatory body that regulates banking institutions and other operators in the financial sector in Malaysia. The main objectives in the establishment of the BNM were to:

- Issue currency and maintain reserves in order to safeguard the value of the currency
- Act as a banker and financial adviser to the government
- Promote monetary stability and a sound financial structure
- Influence the credit situation to the advantage of the country.

Among the examples of legislation enforced by the BNM are:

- Central Bank of Malaysia Act 1958 (revised 1994)
- Banking and Financial Institutions Act 1989 (BAFIA)
- Exchange Control act 1953
- Islamic Banking Act 1983
- Insurance Banking Act 1983
- Insurance Act 1996.

Due to its position as a regulator of some of the regulated industries, the BNM is closely involved in the development of the accounting profession as well as the MASB. Under the BAFIA 1989, the BNM has issued two guidelines relating to the financial reporting practices of financial institutions (Ku Ismail 2003). Those guidelines are: i) BNM/GP3 which informs on the method of income recognition and loan loss provision, and ii) BNM/GP8 which informs on standardising the format of financial reports prepared by

financial institutions. As for insurers, the BNM issued a set of guidelines called ‘Model Accounts for Insurers’ which was subsequently updated in 2001 to incorporate the requirements of the new MASB standards.

### **3.4.5 The Companies Commission of Malaysia (CCM)**

The CCM was established in 2002 as a result of a merger between the Registrar of Companies (ROC) and the Registrar of Business in Malaysia. It is a statutory body that regulates companies and businesses and serves as an agency to incorporate companies and register businesses and provides these entities information to the public. One of the main duties of the CCM is to ensure that companies and their officers comply with the numerous provisions of the Companies Act 1965 which was previously under the responsibility of the ROC.

#### *The Companies Act 1965*

The Companies Act 1965 was based originally on the UK Companies Act 1948. The Act has been amended to take into account the development of the corporate sector and remains the principal company law today (Liew 1997). The Act specifies the rules for pre-incorporation, incorporation, operations and the duties of companies and their directors as well as the rights and obligations of shareholders and directors. The Act also requires companies to keep accounting records so that true and fair statements could be prepared and the record keeping should be kept in such a way that will enable the records to be properly audited.

With regard to auditing, Section 169 of the Companies Act requires directors of every company to present audited financial statements at the company’s annual general meeting and to ensure that the statements give a true and fair view of the company’s affairs and results of its operations. The duties of auditors are specified in section 174 which include:

- Reporting to the members of the company on the accounts

- Ensuring timely submission of the audit report to the company
- Expressing an opinion on the truth and fairness of the financial statements, and
- Ensuring compliance with the requirements of the Companies Act 1965 and the applicable approved accounting standards.

The Act also emphasises the need for auditors to be ‘independent’ in the sense that they are not allowed to be an officer or director or hold shares either directly or indirectly with the companies that they audit. The auditors are also given authorities in matters of inspecting the records and registers of a client company and are entitled to require from any officer of the client company or auditor of a related company such information and explanation as they desire for the purpose of an audit. Even though the primary responsibility of preventing and detecting fraud and other illegal activities in a company rests with the board of the company, the auditors are responsible for planning, performing and evaluating their audit work so as to have reasonable expectation of detecting material misstatements in financial statements. The Act places a statutory duty on auditors to report to the CCM in writing when they are satisfied that there has been a violation of any of the provisions of the act (Thillainathan 1999).

A year after the Companies Act came into existence, the Accountants Act 1967 was passed, requiring that only members of the MIA are allowed to conduct an audit which had not been made clear by the Companies Act 1965 (Ali 2004b).

In 1985, the Companies Act was revised to place greater emphasis on the need for those associated with companies to be more accountable and to provide greater protection for minority shareholders. The amendment of the Act also required for the first time that all public accounting firms and the individual partners of such firms to register with the ROC (Ali 2004b). Each partner was allocated a number that must be cited in all audit reports. As a result, auditors’ works were being monitored from that moment on as only qualified auditors were allowed to conduct audits of companies’ financial statements.



#### **3.4.6 The Malaysian Stock Exchange - Bursa Malaysia**

The Malayan Stock Exchange was established in 1960. It changed its name to the Stock Exchange of Malaysia in 1964 and to the Stock Exchange of Malaysia and Singapore in 1965, subsequent to the withdrawal of Singapore from Malaysia in 1965. The Stock Exchange of Malaysia and Singapore was divided into the Kuala Lumpur Stock Exchange (KLSE) Berhad and Stock Exchange of Singapore when the currency interchangeability between the two countries ceased in 1973. The KLSE was then incorporated in 1976 as a company limited by guarantee to take over the operations of the KLSE Berhad in the same year. The stock exchange again changed its name to the Bursa Malaysia Berhad following its demutualisation exercise in April 2005.

The Bursa Malaysia is responsible for market surveillance, enforcement of listing requirements and supervision of its subsidiaries. It is an organisation managed by a committee that consists of nine members whereby four of the committee members, including the chairman, are appointed by the Ministry of Finance. The Bursa Malaysia is subject to a statutory duty to act in the public interest and is entrusted with the regulatory oversight of the Securities Commission (Liew 2007). Any amendments to the stock exchange's rules require the approval of the Securities Commission.

In 1993, the Malaysian stock exchange's listing requirements were amended to include provisions relating to, among other things, the audit committee. It incorporated the Cadbury Report's recommendations that every listed company is required to form an audit committee, a sub-committee of the board of directors. This was among those efforts to strengthen the regulatory framework of the corporate sector that actually began before the financial crisis in 1997. In response to public demand for greater corporate accountability and the transparency of financial reporting due to the financial crisis, the Bursa Malaysia introduced several new disclosure requirements in 1999 which included the introduction of quarterly reporting that replaced the half-yearly reporting and preliminary requirements (Ku Ismail 2003). The Listing Requirements of the Bursa Malaysia were revamped in 2000 and the new Listing Requirements were issued in 2001, requiring more disclosures prepared on a more regular and timely basis. All listed companies are also required to

disclose non-audit fees in their annual reports. The aim of these measures is to protect shareholders' interests and to increase corporate transparency.

#### **3.4.7 The Securities Commission (SC)**

The SC was established in 1993 under the Securities Act 1993. The functions of the SC are to promote a strong and healthy securities market and to maintain the confidence of investors. Prior to 1993, there was no single Malaysian authority responsible for regulating and developing the capital market. Supervision of the capital market was shared between the stock exchange and government institutions. The SC has wide administrative power but does not have the judicial power of a court. It reports to the Ministry of Finance and its accounts are tabled annually in parliament. The SC's regulatory functions include:

- Supervising changes, clearing houses and central depositories
- Registering authority for prospectuses of corporations other than unlisted recreational clubs
- Approving authority for corporate bond issues
- Regulating all matters relating to securities and futures contracts, unit trust schemes, take-overs and mergers of companies
- Licensing and supervising all licensed persons
- Encouraging self-regulation, and
- Ensuring the proper conduct of market institutions and licensed persons.

All of the above functions can be seen as underpinning the SC's ultimate responsibility of protecting investors. In addition, the SC is also obliged by statute to encourage and promote efficiency, professionalism and the orderly development of both the securities and futures industries (Ali 2006).

Since the economic crisis, it can be said that the functions of the SC are more clearly defined and that policies have been successfully implemented to enhance financial disclosure and corporate governance practices. The SC also acts as the enforcer of the approved accounting standards issued by the MASB. Listed companies are required to file regular detailed annual reports with the SC. The annual reports must be audited and the listed companies must ensure that the annual reports maintain a high standard of financial disclosure so as to allow the public to make informed investment decisions.

The SC has also enhanced its enforcement capacity by restructuring its enforcement department and placing greater emphasis on corporate compliance (Liew 2007). In April 2000, the Securities Commission Act 1993 was amended with enhanced disclosure obligations on listed companies and stringent sanctions for false and misleading information. The Act gives investors the right to pursue civil action against companies, directors and their advisors where there has been a breach of the law. The SC is also empowered to pursue legal action on behalf of investors where it is in the public interest to do so.

In the next section, a discussion on chartered accountant firms in Malaysia will be presented.

### **3.5 Chartered Accountant (CA) Firms in Malaysia**

As of December 2010, there are 2054 firms registered with the MIA, 1363 of them being CA firms, with the remaining 671 being firms that provide services other than audit services. In addition to audit services, these CA firms provide accounting and bookkeeping services, tax services, management consulting services and other services that include financial planning, business valuation, forensic accounting, internal audit outsourcing and information technology advisory services.

The Malaysian CA firms can be categorised into three groups: the Big Four International firms, medium (whether international or local) and small local firms.

- The Big Four firms audit almost 70% of public listed companies in Malaysia, have offices throughout the country and all over the world (Arens et al. 2006).
- The medium size CA firms are large but considerably smaller when compared to the Big Four firms. These firms compete with the Big Four firms particularly for public listed clients as they can also offer the same services. Some of these firms are also affiliated with the non-Big Four international firms and thus possess an international capability.
- The small local firms represent more than 90% of all CA firms in Malaysia. These firms perform audits mainly for smaller companies although some firms may have one or two listed clients. The fact that small firms lack staff resources, technical expertise and global reach to audit public companies with their often-complex operations presents a challenge to these small firms to compete for the auditing contracts of large national and multinational public companies.

In terms of organisational structures, there are only two structures that are available to Malaysian CA firms, namely; proprietorship and partnership. The proprietorship structure includes firms with one owner. Some small local CA firms are organised as proprietorships. The partnership form of organisation applies to firms with two or more owners. Owners or partners are severally and jointly liable for the partnership debts and obligations, their own acts and the acts of others under their supervision.

Similar to many countries, the organisational hierarchy in a typical CA firm in Malaysia includes audit partners, audit managers, senior auditors and junior auditors or audit assistants. A fresh university or college graduate with relevant qualifications (mainly accounting or business and management qualifications) usually starts as an audit assistant and spends about two to three years in each position before achieving partner status. The titles and positions vary from firm to firm but, in general, this process is similar in all.

The following section will discuss the development and characteristics of an audit committee in Malaysian public listed companies.

### **3.6 The Development and Characteristics of an Audit Committee in Malaysian Public Listed Companies**

The development of an audit committee in Malaysia began in 1991 when a memorandum that audit committees be made mandatory for all listed companies was jointly submitted by the MICPA, the MIA and the Institute of Internal Auditors of Malaysia to the ROC, the Capital Issue Commission and the Bursa Malaysia (Haron et al. 2005). Subsequently, Section 15A of the Bursa Malaysia Listing Requirement was introduced, requiring all listed companies to form an audit committee by 1<sup>st</sup> August 1994<sup>16</sup>.

It is believed that the setting up of an audit committee could contribute to effective corporate governance especially with regard to the board of directors' responsibility for the reliability of financial disclosures and its oversight of the effectiveness of risk management, internal control and audit (Haron et al. 2005). An audit committee helps determine indicators of problems and address these problems, mitigate possible damage and enhance shareholder value. However, the audit committee is only effective if it is able to fulfil its roles as stipulated in the rules and regulations and listing requirements. The many corporate collapses after the crisis in 1997 revealed that many of these committees had poorly defined or poorly understood their responsibilities with agendas controlled by the management and inadequate time devoted to their role (Abdul Rahman 2006). As a result, measures needed to be taken so that audit committees can be part of an effective and a strong governance structure.

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<sup>16</sup> A study by Sori et al. (2001) showed that only 56% of the sampled main board firms and 24% of the sampled second board firms had formed an audit committee by 1994. The study also found that it was not until 1998 that all 556 listed firms had formed an audit committee even though it was mandated in 1993.

As an example of best practice, the Malaysian Code of Corporate Governance (MCCG) (MCCG 2000) requires that listed companies establish an audit committee of at least three directors, among whom the majority should be independent directors<sup>17</sup>. To strengthen the role of the audit committee, the MCCG was revised in 2007 and required that all members of the committee should be non-executive directors. In addition, all members should be able to read, analyse and interpret financial statements so that they will be able to effectively perform their function. As stated in Table 3.1, the stock exchange incorporated almost all the best practices in its listing requirements.

**Table 3.1: Composition of Audit Committee**

<p>a) The audit committee must be composed of not fewer than 3 members;</p> <p>b) All members of the audit committee must be non-executive directors, a majority of them must be independent directors;</p> <p>c) At least one member of the audit committee:</p> <ul style="list-style-type: none"> <li>✓ must be a member of MIA;</li> <li>✓ if he is not a member of the MIA, he must have at least 3 years working experience and: <ul style="list-style-type: none"> <li>• he must have passed the examinations specified in Part I of the 1<sup>st</sup> Schedule of the Accountants Act 1967; or</li> <li>• he must be a member of one of the associations of accountants specified in Part II of the 1<sup>st</sup> Schedule of the Accountants Act 1967; or</li> <li>• he must fulfills such other requirements as prescribed by the Exchange.</li> </ul> </li> </ul> <p>d) No alternate director is appointed as a member of the audit committee.</p>
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Source: Bursa Malaysia (2009)

<sup>17</sup> The Malaysian Institute of Corporate Governance (MICG) was established in 1998 to look into the improvements for corporate governance practices in Malaysia. Among its objectives were to represent, express and give effect to opinions of members of MICG on issues relating to corporate governance and promote awareness of corporate governance principles among corporate participants and investing public and corporations. The MCCG was drawn up in March 2000 and provided guidelines on principles and best practices in corporate governance and the direction for their implementation.

The listing requirements also required that all public listed companies to include the Audit Committee Report in their annual reports. The Audit Committee Report should inform readers as to the composition of the audit committee, the existence of written terms of reference for the audit committee to refer to, the number of meetings held and the attendance of the directors, a summary of audit committee's activities and a summary of internal audit activities.

The next section will discuss the recent initiative launched by the Malaysian government in seeking to achieve better corporate governance through the establishment of the AOB.

### **3.7 The Audit Oversight Board (AOB)**

The increase in fraudulent practices among the local listed companies had raised concerns regarding the credibility of the local accounting profession and this has prompted the need for reform in the local audit oversight system (Abdul Wahab 2008; Lee and Ali 2008; Gomes 2010). In 2007, plans to establish an audit oversight board were already in the pipeline when the Prime Minister announced in his Budget 2008 presentation that a PCAOB will be established under the SC. In 2008, the Commission formed a High Level Task Force to deliberate on the appropriateness of the AOB framework for Malaysia. In December 2009, Part IIIA of the Securities Commission Act 1993 introduced a new audit oversight framework for Malaysia that was approved in Parliament by virtue of the Securities Commission Amendment Act 2010 (AOB 2010).

The missions of the AOB are to oversee the auditors of public interest entities and protect investors' interests by promoting confidence in the credibility of audited financial statements. The AOB is responsible for, among others things:

- 1) Implementing policies and programs to ensure an effective audit oversight system in Malaysia
- 2) Registering auditors of public interest entities

- 3) Directing the MIA to establish or adopt auditing and ethical standards to be applied by auditors
- 4) Conducting inspections and monitoring programs on auditors to assess the degree of compliance on auditing and ethical standards, and
- 5) Conducting enquiries and imposing appropriate sanctions against auditors who fail to comply with auditing and ethical standards.

The Malaysian AOB will work with other players in the accounting profession such as the CCM, the Central Bank as well as the MIA. It is empowered to share information with these bodies, granting it a wider regulatory and enforcement reach. In other words, the AOB will facilitate regulatory oversight and enforcement in the wake of the local corporate scandals and global financial crisis that have tested the capital market regulators and placed new demands and responsibilities on both institutional and independent regulation (Gomes 2010). The collaboration with the accounting profession particularly the auditing sector, is crucial to the success of the AOB. In this respect, both parties have their respective roles to play in developing the auditing profession especially in the domain of the public listed companies. The AOB will complement the function of the MIA as a regulatory body in Malaysia.

### **3.8 Chapter summary**

This chapter provides a review of the Malaysian social, economic and institutional background as well as the origin of the accounting and auditing practices in Malaysia. Since the independence of Malaysia from its former colonial master, Britain, much of the accounting practices, rules and regulations continued to mirror those of the British colonial administration. The Asian financial crisis in 1997 caused disruption to the country's increasing economic growth. The weakness in the country's banking system and the absence of a strong governance framework were predominantly blamed among the factors that perpetuated the crisis in Malaysia. The formation of various bodies by the government has sped up the recovery process from the crisis. Since the crisis, the role of the accounting



profession has been enhanced particularly that of auditors as they are directly connected with the credibility of a company's financial reporting. In addition, the existence of a strong accounting profession has come to be regarded as a significant factor in ensuring investors' confidence in a capitalist market system that had been affected by the crisis. The roles of such key players in the accounting profession as the MICPA, MIA, Bursa Malaysia, the SC and the central bank, have each been discussed in this chapter.

This chapter also provided a brief overview of the development of audit committee in Malaysian public listed companies. The role of an audit committee is to ensure that the 'checks and balances' mechanism in an organisation is firmly in place. This chapter further highlights the recent initiative by the Malaysian government in improving the corporate governance practices through the establishment of the AOB. The AOB is expected to monitor the auditors of public interest entities and protect investor's interests by promoting confidence in the quality and reliability of their audited financial statements (Gomes 2010). The current study has been motivated to investigate whether these initiatives (the strengthening of the audit committee's functions and the establishment of the AOB) could bring improvements in the auditing sector, particularly in auditor independence behaviour in the Malaysian capital market.

In short, it is important to review the setting of the current research as it will provide further understanding of the issues under study. Conducting the current research in these time and economic settings (i.e. in the post-SOX 2002 period and subsequent to the incidents of accounting scandals involving Malaysian listed companies) may have some theoretical implications particularly in explaining Malaysian respondents' perceptions of auditor independence in comparison with prior studies, specifically those conducted in developed countries. In addition, the introduction of the new institutional feature in this country, the AOB, may also have some theoretical impacts on the independence issues covered by the thesis. The existence of the AOB indicated the public support for regulatory intervention to avoid future misconduct (Hirshleifer 2008), even though the new regulation is "largely process and compliance driven" (Beattie et al. 2013, p 77).

The following chapter presents the research objectives, research questions and the development of the research hypotheses of the current study.

## **CHAPTER 4 – DEVELOPMENT OF THE RESEARCH HYPOTHESES**

### **4.1 Introduction**

Presented in Chapter 2 was a review of the literature in the area of auditor independence. The literature review helps the current study in developing a good understanding and insight into relevant previous research and into the various identifiable trends that have emerged. This chapter is followed by Chapter 3 which provided background information concerning Malaysia in general and the Malaysian accounting and auditing environment in particular. An understanding of the research background is important because it contributes to a greater understanding of the issues under scrutiny in the context of its research setting.

The current chapter highlights the objectives of the current study, the research questions and the development of the research hypotheses. The chapter is divided into five sections. Section 4.2 describes the research objectives of the current study. This is followed by Section 4.3 which explains and justifies the research questions. Based on these research questions, the research hypotheses are developed and discussed in Section 4.4. Finally, a summary of this chapter is presented in Section 4.5.

### **4.2 Research objectives**

The objectives of the current study are derived mainly from the issues arising from, and the research gaps highlighted in, the literature review. The research objectives provide a focus for the research and help the researcher to develop the research questions. The following are the objectives of the current research:

- 1) To investigate the impact of the following independent variables, namely: i) a lengthy relationship between audit firms and their audit clients, ii) audit firms' and audit partners' financial dependency on income from a single audit client, iii) the provision of NAS to audit clients, iv) former auditors' employment with audit clients, and v) the existence of an audit committee, on perceptions of

auditor independence from the perspectives of loan officers and professional investors in Malaysia.

- 2) To analyse the perceptions of factors that may mitigate those problems surrounding auditor independence.
- 3) To examine whether the demographic characteristics of the respondents such as accounting qualifications, prior working experience as auditors or accountants, age, gender, and the type of respondents, affect their perceptions of whether the variables in (1) affect auditor independence.

### **4.3 Research Questions**

The following research questions are developed in order to achieve the research objectives that are based primarily on an extensive review of the literature, the IFAC (2009) and the current By-Laws of the MIA. The research questions provide direction for the current study and guide the construction of the questionnaire that will be discussed in Chapter 5. This study attempts to provide answers to the research questions. The rationales for each of these questions are explained as follows:

#### **4.3.1 Research Question 1**

*What are the perceptions of loan officers and professional investors regarding the impact on auditor independence when there is a lengthy relationship between audit firms and their audit clients?*

Research Question 1 arises due to the ongoing debate that long-term audit tenure could threaten auditor independence. The literature review in Chapter 2 revealed arguments that long-term auditor-client relationships may cause auditors to get too close to their audit clients (Mautz and Sharaf 1961; Gates et al. 2007). This closeness may lead to auditors expressing too much confidence in the clients, having a lack of innovation, becoming complacent and applying less rigorous audit approaches (Shockley 1981). Others,

however, have reported that long audit tenure helps auditors to better understand the clients' business and identify key audit risks, resulting in higher quality audits (Geiger and Raghunandan 2002; Daniels and Booker 2009). Based on these debates, the current study intends to investigate whether lengthy relationships between auditors and their clients affect financial statements users' perceptions of auditor independence. Providing answer to this question is important as it determines whether or not audit partners or audit firms should be rotated. As the results in prior studies have been conflicting, more research is needed to support the arguments for or against auditor rotation. In addition, since no prior Malaysian studies have examined investors' perceptions and since perceptions may have changed after the recent financial scandals involving local companies, the current study aims pursue this issue.

#### **4.3.2 Research Question 2**

*What are the perceptions of loan officers and professional investors regarding the impact on auditor independence when audit firms and audit partners are financially dependent on income they derive from a single audit client?*

Research Question 2 is based on the argument that the potential impact on auditor independence due to receiving high audit fees is just as damaging as receiving significant amounts from NAS. Khurana and Raman (2006) revealed that subsequent to SOX 2002, audit firms' income from audit fees have increased significantly compared to NAS fees but research tends to overlook this important area. This is evident as many recent behavioural studies have placed more emphasis on the economic bonding arising from NAS provision to audit clients, ignoring the possible adverse impact that audit fees may have on the auditors' ability to remain independent. This research question is important in providing support for the rule that limits the income that auditors can receive from an audit client. The threat of economic dependence could be reduced if users perceive that the limit imposed could safeguard auditor independence.

### 4.3.3 Research Question 3

*What are the perceptions of loan officers and professional investors regarding the impact on auditor independence when auditors provide NAS to existing audit clients?*

Research Question 3 is based on the review of NAS literature which revealed two opposing views. On the one hand, it is argued that NAS provision to audit clients will improve audit effectiveness due to a knowledge spill-over (Simunic 1984; Arrunada 1999) and auditors' unique position in relation to the clients (Goldman and Barlev 1974), thus strengthening the auditors' independence. It is also claimed that when NAS are provided to audit clients, the auditors can make better "grounded professional judgment" since they have greater depth of knowledge of the clients' business as compared to the situation if they provided audit services alone (Arrunada 1999, p. 514). On the other hand, it is argued that the economic bond between auditors and their audit clients will be strengthened due to the income from NAS (Simunic 1984). The strong economic bond between the two may affect the auditors' ability to remain independent since they may be reluctant to question possible misstatements of the clients' financial statements (Kinney et al. 2004). For fear of losing the lucrative income from NAS, auditors may also tend to make difficult audit decisions in favour of the clients (Basioudis et al. 2008).

This research question therefore sets out to explore financial statement users' perceptions of auditor independence when auditors provide NAS to existing audit clients. This question is important since findings in prior research have been mixed and inconclusive and more research needs to be conducted to resolve the debate over the provision of NAS. The literature review also revealed that most of the previous behavioural studies were conducted prior to the growth in NAS fees during pre-Enron period. Hence, the current study attempts to provide new evidence on auditor independence perceptions by directly investigating the view of loan officers and professional investors in Malaysia. The new evidence could help the accounting regulators in the country to review the current independence rules on NAS by gathering opinions of the main users of audited financial statements. Since one of the main objectives of independence rules is to promote investors'

confidence in the financial statements of public companies, their opinions are relevant and valuable in answering all the research questions in this study.

#### **4.3.4 Research Question 4**

*What are the perceptions of loan officers and professional investors regarding the impact on auditor independence when auditors accept employment with an audit client?*

This research question is very important for three reasons. First, as mentioned in Chapter 1, research in the area of auditor employment with an audit client is growing. DeFond and Francis (2005) suggested that this area will continue to be an important issue and more research is desirable due to the effect it may have on accounting firms. Second, previous studies in this area focused on whether auditor independence in appearance is affected by three factors: i) auditors' prior position in the audit firm, ii) auditors' subsequent position at the client company, and iii) the time lapse before the auditors accepted employment with an audit client. Consistent with the regulators' concerns, these three factors may lead to self-interest, familiarity and intimidation threats, particularly when significant connections remain between the ex-auditors and the remaining audit engagement team. And third, no prior studies have examined the perceptions of professional investors on these issues. As one of the users of audited financial statements, they might also have concerns. Thus, it is the intention of the current study to fill these gaps.

#### **4.3.5 Research Question 5**

*What are the perceptions of loan officers and professional investors regarding the impact on auditor independence when an audit committee exists in a client company?*

This research question seeks the respondents' agreement as to whether the existence of an audit committee affects their perceptions of auditor independence. The literature review in Chapter 2 pointed out findings in behavioural studies that are conflicting which may be attributed in part to the fact that these studies only investigate the existence of audit

committees in general. On the other hand, the results in prior archival studies seemed consistent since they specifically examined independent, expert and active audit committees and their impact on the quality of financial reporting. Given that the current characteristics of an audit committee have been enhanced, it is crucial to determine whether these characteristics (such as independence, having financial expertise, active and having compulsory audit committee report) could enhance auditor independence from the users' perspective.

#### **4.3.6 Research Question 6**

*What are the perceptions of loan officers and professional investors regarding the impact on auditor independence when other safeguards are in place?*

Research Question 6 attempts to directly investigate the impact of other safeguards (that have been reported in the literature) on perceptions of auditor independence from the perspective of financial statements users in Malaysia. For example, Gul and Yap (1984) suggested that disclosures of non-audit fees would provide a better understanding of the auditor-client relationship. Beasley et al. (2000) highlighted the Independence Standard Board's (ISB) suggestions to safeguard auditor independence from employment with audit clients' problems such as the need for a subsequent review of audit work by another audit senior while a recent study by Dart and Chandler (forthcoming) put forward a total ban on such employment practices. Other studies such as Johnstone et al. (2001), presented an independence risk framework which includes safeguards to auditor independence such as the requirement of a concurring partner to conduct reviews, peer reviews for the auditing of listed companies, auditor competence programs and the audit firm culture, all of which have the potential to mitigate auditor independence problems. In addition, recent reforms undertaken by the Malaysian regulators to enhance audit quality through practice review and the establishment of the AOB could also influence perceptions of auditor independence. The users' opinions on these issues are important since they provide evidence of how they would regard the various safeguards being considered by the literature and the profession.



#### **4.3.7 Research Question 7**

*Is there any relationship between loan officers' and professional investors' background variables (such as accounting qualification, prior working experience as auditors or accountants in industry, age, gender and type of respondents) and their perceptions of auditor independence?*

This research question is based on the argument that respondents' background variables could affect their perceptions of auditor independence. However, most of those prior studies that examined the impact of accounting qualifications (Pany and Reckers 1983, 1984; Bartlett 1993) and prior working experience as auditors or accountants (Imhoff 1978; Firth 1980; Shockley 1981) on independence perceptions are dated, thus gathering of more recent evidence is needed. Respondents' gender and age are also included since it is expected that these variables could influence their perceptions. In addition, the current study intends to examine the impact of the type of respondents as prior literature mainly focused on differences among auditors' and financial statement users' perceptions, failing to recognise that the perceptions of different users may also differ. As regulators should consider the users' views when revising existing rules or standards, it is considered important that this issue is investigated here.

Based on the research questions discussed in this section, the following section discusses the hypotheses developed for the current study.

#### **4.4 Hypotheses Development**

This section discusses the development of the research hypotheses. The research hypotheses expand on the research questions by providing detail (Hussey and Hussey 1997). In this study, the research hypotheses are built based on the research questions, extensive review of the literature and review of the IFAC (2009) and current By-Laws of

the MIA. The following sub-sections present the hypotheses developed for the current study.

#### **4.4.1 Long audit tenure**

The arguments that lengthy audit tenure could threaten auditor independence have been discussed in detail in Chapter 2. Due to the ongoing debate in this area and the inconsistent results in prior research, the first hypothesis of the current study is stated in its null form as follows:

*H<sub>1a</sub>: The length of auditor tenure will not affect loan officers' and professional investors' perceptions of auditor independence.*

Subsequent to the collapse of Enron, the US regulators' concerns that long audit tenure represents a familiarity threat to independence were manifested in the rules of SOX 2002 that mandate the rotation of engagement audit partners every five years (SEC 2003). A similar requirement was also imposed by the APB on engagement audit partners in the UK (APB 2009) while the IFAC requires audit partners to be rotated after a period of seven years (IFAC 2009).

Studies that examined the impact of audit partner rotation on auditor independence demonstrated mixed findings even though the policy of mandatory audit partner rotation is preferred to audit firm rotation. Several archival studies found some evidence to support the claim that audit partner rotation brings fresh eyes to the engagement (Fargher et al. 2008; Hamilton et al. 2005; Chen et al. 2008) but other studies failed to provide support for audit partner rotation (Carey and Simnett 2006; Chi et al. 2005). Based on the inconsistent results in prior research, the next hypotheses of the current study are stated in their null form as follows:

*H<sub>1b</sub>: Audit partner rotation will not affect loan officers' and professional investors' perceptions of auditor independence.*

*H<sub>1c</sub>: Loan officers and professional investors perceive that the audit partner rotation policy should not be replaced with an audit firm rotation policy.*

#### **4.4.2 Financial dependence on a single audit client**

The review of the literature showed that most behavioural studies reported a negative effect on perceived independence when audit firms are financially dependent on audit fees (Firth 1980, 1981; Dyxhoorn and Sinning 1982; Gul 1991, Teoh and Lim 1996; Beattie et al. 1999). In contrast, the findings in prior archival studies attempting to measure the impact of audit fees on surrogates of actual auditor independence failed to find any significant impact (Craswell et al. 2002; DeFond et al. 2002; Callaghan et al. 2009).

The lack of current behavioural research focusing on financial dependence due to audit fees seems to suggest an urgent need for further study. In addition, since most prior studies seemed to focus on an *audit firm's* financial dependence on audit fees from a single audit client, this study will also focus on how independence perceptions may be affected when an individual *audit partner's* income is dependent on fees generated from a single client.

The conflicting findings in recent behavioural studies and archival studies lead to the development of the next hypotheses of the current study which are stated in their null form:

*H<sub>2a</sub>: Loan officers' and professional investors' perceptions of auditor independence will not be affected by the dependence of the audit firm on income from a single audit client.*

*H<sub>2b</sub>: Loan officers' and professional investors' perceptions of auditor independence will not be affected by the dependence of an individual audit partner on income from a single audit client.*

The APB in the UK (APB 2010) and the IFAC Code of Ethics (IFAC 2009) have mandated a limit of 10% and 15% respectively, on the total income that audit firms may receive from a single listed audit client. Even though the regulators only emphasised total

income and did not state the maximum percentage for audit fees or other fees that auditors may receive from a single audit client, this was enough to reflect the regulators' concern that allowing auditors' financial dependence to exceed the stated percentage could pose a significant threat to their independence. The current study investigates whether financial statement users perceive that the IFAC rule (which is echoed by the MIA By-Laws) to limit audit firms' total income from an audit client to 15% would be sufficient to safeguard auditor independence from problems that may arise due to fee dependence. Therefore, it is hypothesised that:

*H<sub>2c</sub>: A 15% limit on audit firms' total income that the firms may receive from any one client is not sufficient to safeguard auditor independence from problems that may arise due to fee dependence.*

#### **4.4.3 Provision of NAS to audit clients**

Based on the literature review in Chapter 2, it can be seen that the provision of NAS by audit firms to their audit clients has long been a contentious issue (Goldman and Barlev 1974; Simunic 1984; Basioudis et al. 2008). The findings in most of the behavioural studies advocate that the provision of NAS to audit clients negatively affect respondents' perceptions of auditor independence (e.g. Firth 1980, 1981; Canning and Gwilliam 1999; Quick and Warming Rasmussen 2005, 2009). On the other hand, the literature review also highlights evidence that most archival research failed to support the argument against the provision of NAS to audit clients (e.g. Ashbaugh et al. 2003; Mitra 2007; Cahan et al. 2008).

The inconsistent results from these prior studies suggest opportunities for future research (Larcker and Richardson 2004). The current study attempts to reconcile these conflicting findings by using a behavioural research methodology and by examining more directly the perceived impact of NAS provision on auditor independence from financial statement users' point of view. The conflicting findings also lead to the next hypothesis of the current study, stated in its null form:

*H<sub>3a</sub>: The provision of NAS by audit firms to audit clients will not affect loan officers' and professional investors' perceptions of auditor independence.*

Hypothesis 3a is based on the concerns that NAS provided to audit clients may impair auditor independence. In order to mitigate this problem, Hillison and Kennelley (1988) suggested the separation of staff for audit and NAS or to spin-off NAS into different divisions within the audit firms. Mautz and Sharaf (1961), Arrunada (1999) and the IFAC (2009) agreed that the segregation of duties for audit and NAS staff would safeguard independence.

In line with the requirement for staff separation by the IFAC, the literature review revealed consistent results concerning the positive impact of separating the staff to perform audit and NAS on auditor independence (e.g. Pany and Reckers 1984; Canning and Gwilliam 1999; Swanger and Chewning 2001). However, studies conducted during the post-Enron period exhibited conflicting results. Quick and Warming-Rasmussen (2005) discovered that the joint provision of audit and NAS by staff from separate divisions did not increase the level of trust in audit functions. This finding contradicted the result in their recent study which found in accordance with majority of prior empirical results (Quick and Warming-Rasmussen 2009).

Influenced by the inconsistency of the findings in recent studies on the separation of staff for audits and NAS, the next hypothesis of the current study is stated in its null form:

*H<sub>3b</sub>: There is no significant difference in loan officers and professional investors' perceptions of auditor independence when NAS are performed by the same audit personnel and when the staff for audit and NAS are separated.*

The next hypothesis is based on the argument that the relative size of NAS fees (as a percentage of audit fees or total fees) could influence auditor independence (Pany and Reckers 1983; Beatie et al. 1999). The regulators are concerned that lucrative NAS may

negatively affect auditor independence and auditors' decisions particularly when those decisions involve substantial amounts of professional judgment (Basioudis 2008; Sharma and Sidhu 2001). Geiger and Rama (2003, p. 53) argued that a higher magnitude of NAS fees received from audit clients would increase the clients power over the auditors and may make the auditors "see things the client's way".

To date, regulators such as the IFAC and the MIA have been silent with regards to the proportion of NAS fees to total fees (or audit fees) and only considered independence to be impaired if the total fees (from audit and/or non-audit services) from an audit client exceed 15% of audit firms total revenues. The SOX 2002 required that NAS provided to any audit client should not be more than 5% of total revenues paid by the audit client to the auditor in the year the services are provided, otherwise, pre-approval from the client's audit committee is required (SEC 2003). In their interview of senior partners of two of the then Big Six accounting firms in Malaysia, Teoh and Lim (1996) found that consultancy fees made up at least 20-30% of the firms' total revenues. However, the percentage of NAS fees seemed to have been increasing by 2002, as Che Ayoib et al. (2006) revealed that 21% of the auditors of NAS-purchased companies had a more than 60% proportion of NAS fees to total fees and considered that situation worrying. It is the intention of the current study to determine whether the respondents in this study perceive there is a need for the regulator to prescribe a maximum percentage of NAS fees to total fees that audit firms may receive from a particular audit client.

Based on the above discussion, the next hypothesis of the current study is stated in its null form as follows:

*H<sub>3c</sub>: The maximum percentage of non-audit fees to total fees paid by a particular audit client should not be prescribed by the accounting regulators.*

In Chapter 2, the literature review demonstrated that the likely impact of different types of NAS on independence may vary from service to service. Even though early research showed no significant difference in the perceptions of auditor independence (Pany and

Reckers 1984), recent literature demonstrated more negative perceptions when legal services and accounting and bookkeeping services are provided to audit clients (Quick and Warming-Rasmussen 2005, 2009). Quick and Warming-Rasmussen (2009) found that other types of NAS (19 types of NAS in total) were perceived as independence impairing with services that create the self-review threat and advocacy threat resulting in negative perceptions. Colbert et al. (2008) reported that FISDI have no significant effect on independence perceptions, nor on the reliability of financial statements and loan decisions, whereas tax services negatively affected the three dependent variables under study.

Based on the above findings, the next hypothesis of the current study is stated in its null form as follows:

*H<sub>3d</sub>: The type of NAS provided to audit clients has no impact on loan officers' and professional investors' perceptions of auditor independence. .*

#### **4.4.4 Ex-auditors' employment with audit clients**

The review of the literature on ex-auditors' employment with audit clients showed that findings in behavioural and archival studies seemed to be consistent with the suspicion that the 'revolving door' practice has a negative impact on auditor independence. Prior studies also found evidence that auditors holding supervisory positions in their audit firms prior to joining their clients, along with their subsequent positions involving preparations of financial statements, affected the independence position of current auditors (Imhoff 1978; Koh and Mahathevan 1993).

The current paucity of research on the effect of ex-auditors' employment with audit clients on perceptions auditor independence suggests opportunities for new studies in this area. As stated by Dart and Chandler (forthcoming, p. 17), "the question of ex-auditor employment perhaps deserves rather more academic attention than it has so far received". Due to the lack of recent evidence, the next hypotheses can be stated in their null forms as follows:

- H<sub>4a</sub>: The practice of ex-auditors seeking employment with their audit clients will not affect loan officers' and professional investors' perceptions of auditor independence.*
- H<sub>4b</sub>: There is no significant difference in the respondents' perceptions of auditor independence when the ex-auditor was an audit partner and not an audit partner.*
- H<sub>4c</sub>: There is no significant difference in the respondents' perceptions of auditor independence when the ex-auditor's subsequent position at a client company involves and does not involve preparation of the company's accounts.*

Regulators such as the SEC in the US and the IFAC have ruled that audit firms are not allowed to perform an audit for a listed client unless a cooling-off period of 1 year is observed before an audit partner begin working for that listed client as a director or employee that has a significant influence over the preparations of the client's financial statements (SEC 2003; IFAC 2009). The MIA By-Laws require a cooling-off period of 2 years since the last audit report for which an audit partner was responsible as an effort to mitigate the threat of compromised independence (MIA 2010). Results from prior studies indicated that a cooling-off period can significantly reduce the negative impact on perceived independence from the revolving door phenomenon (Imhoff 1978; Koh and Mahathevan 1993). However, the perceived impact of the current rule on independence has not been adequately investigated, providing a gap for the current study to fill. Therefore, the next hypothesis of the current study can be stated in its null form as follows:

- H<sub>4d</sub>: A 'cooling-off' period of 2 years that audit firms must observe before audit partners join an audit client is not sufficient to safeguard auditor independence from problems that may arise due to employment with audit clients.*

#### **4.4.5 Audit committees**

In Chapter 2, the literature review revealed evidence that auditor independence could be enhanced when audit committees are present in a client company. The existence of audit committees limits the management's powers over the auditors when they are involved in



selecting the auditors and determining the auditors' remuneration and retention/dismissal (Goldman and Barlev 1974). Sori et al. (2009) provided evidence that auditor independence would be safeguarded when audit committees assume the role of approving audit fees. According to them, a strong audit committee will review audit fees more impartially, without any vested interests influencing the outcomes of financial reporting and auditing services.

However, there were studies finding the existence of audit committees not to be a significant factor in enhancing the perception of auditor independence (Gul 1989 Cheung and Hay 2004). The conflicting nature of these findings may be due to some of these studies only examined the impact of the audit committee's existence on independence in general (Teoh and Lim 1996; Gul 1989), whereas studies such as Beattie et al. (1999; 2013), Alleyne et al. (2006) and Sori et al. (2009) emphasised the importance of audit committees to be independent in their investigations. This characteristic is very important since being independent means the audit committees are not associated with the company as employees, thus able to oversee the audit process without the management's influence.

The literature review also revealed that audit committees' responsibilities involve dealing with complex accounting issues, internal control and other financial matters (Abbot et al. 2004). The current rule requires that the audit committees be active (by convening for regular committee meetings) and that they consist of at least one member with accounting and related financial expertise (Bursa Malaysia 2005). Even though it is important that audit committees be active and have financial expertise, only one behavioural study, Sori et al. (2009), has examined the impact of the two characteristics on perceptions of auditor independence. Beattie et al. (2013) examined the impact on audit quality of having an audit committee with at least one member with financial expertise and found that the factor was among the most highly rated factors that could enhance audit quality.

In addition, the Bursa Malaysia's listing requirements require the audit committees of Malaysian public listed companies to disclose their findings in the annual report (Bursa Malaysia 2005). As with the audit committees' characteristics identified above, only Sori

et al. (2009) have examined whether auditor independence would be better safeguarded if audit committee reports be made compulsory in the annual report. The relevant disclosures on audit committees, their activities and their interaction with the auditors and management, could improve investor confidence in the financial reporting process and quality (Sori et al. 2009).

Based on the conflicting findings in prior studies and the apparent gap in the literature regarding audit committees' characteristics and the effect on perceptions of auditor independence, the following hypotheses are stated in their null form:

- H<sub>5a</sub>: The existence of audit committees responsible for the appointment and reappointment of external auditors will not affect loan officers' and professional investors' perceptions of auditor independence.*
- H<sub>5b</sub>: The existence of audit committees responsible for review and approval of audit fees will not affect loan officers' and professional investors' perceptions of auditor independence.*
- H<sub>5c</sub>: The existence of independent audit committees will not affect loan officers' and professional investors' perceptions of auditor independence.*
- H<sub>5d</sub>: The existence of at least one audit committee member with accounting and financial expertise will not affect loan officers' and professional investors' perceptions of auditor independence.*
- H<sub>5e</sub>: The existence of active audit committees will not affect loan officers' and professional investors' perceptions of auditor independence.*
- H<sub>5f</sub>: The existence of compulsory audit committee reports in the annual reports of a listed company will not affect loan officers' and professional investors' perceptions of auditor independence.*
- H<sub>5g</sub>: Loan officers' and professional investors' perceptions of auditor independence will not be affected when external auditors report to and are monitored by the audit committee.*

## **Demographic Variables**

The following hypotheses are based on factors chosen primarily to assist the current study in understanding respondents' backgrounds. Prior studies have shown that these variables have the potential to affect the respondents' perceptions of auditor independence, and will thus be examined in the current study.

### **4.4.6 Respondents' accounting qualifications**

The literature revealed several critics of independence studies as suggesting that the more knowledgeable respondents are about auditing and the profession, the more likely they are to perceive auditors to be independent (Burton 1980; Mednick 1990). In response to the critics, several studies have been conducted; all failing to find evidence that accounting and auditing knowledge have influence on perceptions of auditor independence (Pany and Reckers 198, 1984; Bartlett 1993; Dart 2011). Since most of the studies are dated, the current study intends to provide more recent evidence by re-examining the argument that respondents' knowledge of accounting and auditing functions have a significant impact on perceptions of auditor independence. The next hypothesis is stated in its null form as follows:

*H<sub>6</sub>: There is no significant difference in the perceptions of auditor independence between respondents with and respondents without an accounting qualification.*

### **4.4.7 Respondents' prior experience in accounting firms or as accountant in industry**

In Chapter 2, Firth (1980) argued that respondents who have previously worked as auditors or accountants in industry may be less worried about auditor independence and that their perceptions may mirror the preparers' perceptions. Prior studies have also indicated that financial statement users were more sceptical about auditor independence than were accountants working in public practice (Imhoff 1978; Firth 1980; Shockley 1981, Beattie

et al. 1999). Therefore, it can be argued that if the financial statements users in this study have prior experience as auditors or accountants in industry, they may perceive the question of independence differently from those without the experience. The next hypothesis can be stated in its null form as follows:

*H<sub>7</sub>: There is no significant difference in the perceptions of auditor independence between respondents with prior experience and respondents without prior experience in accounting firms or as accountants in industry.*

#### **4.4.8 Age**

Prior studies in business ethics research suggested that respondents' age may have the potential to influence ethical beliefs and behaviours. Studies such as Peterson et al. (2001), who examined business professionals, and Deshpande (1997), who examined middle-level managers, reported that ethical awareness increases with age of respondents in their studies. These findings suggest that, as the respondents grow older, they tend to become more conservative in their ethical perspectives. The implication of age for the current study could be that a younger respondent may be less concerned about the potential of independence-threatening factors such as NAS and long audit tenure compared to older respondents. It may be worth looking at how financial statements users' age could affect their perceptions of independence. The next hypothesis of the current study is stated in its null form:

*H<sub>8</sub>: There is no significant difference in the perceptions of auditor independence between respondents of different ages.*

#### **4.4.9 Gender**

The social role theory states that men may focus more than women on monetary evidence of business success and that they also appear more likely to recognise ethical problems involving money such as cash bribes and non-cash gifts (Franke et al. 1997). This

emphasis may be relevant to the current study since there is a possibility that male respondents may be more concerned about the impairment of auditor independence in fact since it involves actual monetary impact and that they may be less concerned about factors affecting independence in appearance. However, the findings in Deshpande (1997) and Peterson et al. (2001) contradicted the social role theory; each found that female business professionals showed a higher level of ethical beliefs than did male respondents. Iyer and Raghunandan (2002) found evidence to support the social role theory; they found that male CPA firm alumni were more likely to indicate that they could resolve disagreements more easily than their female counterparts.

As mentioned in Chapter 2, it is likely that female respondents will be more concerned about auditor independence impairment due to their caring personality while male respondents may be less worried since they are more concerned about financial evidence of independence impairment. However, given that the impact of gender on auditor independence has not been the focus of many previous studies, the next hypothesis is stated in its null form:

*H<sub>0</sub>: There is no significant difference in the perceptions of auditor independence between male and female respondents.*

#### **4.4.10 Loan Officers / Professional Investors: Differences in Perceptions of Auditor Independence**

This study will focus on loan officers' and professional investors' perceptions of auditor independence. The two groups of respondents were chosen because they are among the main users of audited financial statements and are likely to appreciate auditor independence (Firth 1980). Prior studies revealed that the users' of audited financial statement were more concerned about auditor independence than were the auditors (Imhoff 1978; Firth 1980; Quick and Warming-Rasmussen 2005). Nevertheless, the specific self-interest and the different demographic backgrounds of these groups may lead to different stated perceptions and motivations for lending and investing decisions. It may be argued

that professional investors may be more concerned about issues relating to auditor independence than are loan officers since it is they who provide investment advice to institutional and private investors. Not only would their own reputation and credibility be jeopardised, those who rely on their investment recommendations would also be affected. Moreover, loan officers may be less worried about the risk of auditors losing their independence since major loans provided by the banks are normally backed by assets of the loan applicants. However, it could also be argued that the loan officers may be more concerned about auditor independence issues as the risk of making poor lending decisions would increase their banks' non-performing loans. Based on these arguments, the current study will investigate if there is any significant difference between the loan officers' and professional investors' perceptions of auditor independence. The next hypothesis is stated in its null form:

*H<sub>10</sub>: There is no significant difference between loan officers and professional investors in their perceptions of auditor independence.*

#### **4.5 Chapter summary**

This chapter outlines the objectives of the current study, followed by the research questions derived from the research objectives, the extensive review of the literature, the IFAC and the MIA By-Laws. There are seven research questions to be answered in this study. Four of them are related to the potential threats to auditor independence (long audit tenure, financial dependence, NAS and ex-auditors' employment with audit clients), two are related to safeguards of auditor independence (the existence of audit committees and other potential safeguards) and one is related to the impact of respondents' background variables on their perceptions of auditor independence. The rationale behind each of the research questions is also explained in this chapter. Based on these research questions, the research hypotheses were developed. All hypotheses developed in Section 4.4 have been stated in their null form.

The following chapter will discuss the research methodology utilised by the current study.

## **CHAPTER 5 - RESEARCH METHODOLOGY**

### **5.1 Introduction**

The previous chapter described the objectives of the current study, presented the research questions and discussed the development of the current research hypotheses. This chapter aims to provide detailed explanations of the research methodology employed in this study. The chapter is organised as follows. Section 5.2 discusses the two main research paradigms and research methods for the current study. This is followed by Section 5.3 that justifies the choice of research method used in this study. Sections 5.4 and 5.5 elaborate in detail the process of questionnaire design and questionnaire rationale, respectively. Section 5.6 explains briefly the ethical guidelines with which the current study has to comply. Section 5.7 explains the need for pilot testing the questionnaire. Section 5.8 describes the sample selections. Section 5.9 discusses the process of questionnaire administration. This is followed by Section 5.10 and 5.11 which explain the importance of detecting non-response bias and self-selection bias respectively. The importance of assessing the reliability of questionnaire data is discussed in Section 5.12. The statistical techniques that will be employed to analyse the questionnaire data are discussed in Section 5.13. Section 5.14 offers a summary of the entire chapter's contents.

### **5.2 Research Paradigms and Research Methods**

The starting point in choosing the most appropriate methodologies for this research is to consider the current research paradigm. A research paradigm is defined by Collis and Hussey (2009, p. 11) as:

*a framework that guides how research should be conducted, based on people's philosophies and assumptions about the world and the nature of knowledge.*

Two main research paradigms have been subject to debate among social science researchers. They are the positivistic and the phenomenological paradigms. According to Collis and Hussey (2009) a positivist research paradigm is based on the ontological assumption that social reality is objective and external to the researcher. Thus, positivists believe that the researcher does not influence the subject of the research. The epistemological position of positivism believes that only phenomena that are observable and measurable can be validly regarded as knowledge (Collis and Hussey 2009). Researchers adopting a positivistic paradigm often seek facts and find out the causes of social phenomena through objective analysis, by defining variables of the phenomena and explaining the relationship between those variables.

On the other hand, a phenomenological or interpretative paradigm is based upon the ontological assumption that the world is socially constructed and can only be understood by examining the perceptions of the individual research subject (Collis and Hussey 2009). Reality is believed to be subjective and depends on the research subject's interpretation of it. Adopting this paradigm, researchers are involved with the research subject, thus "the act of investigating reality has an effect on that reality" (Hussey and Hussey 1997, p. 53). As a result, the distance between the researcher and the subject that is being researched is minimised through an interactive link so that findings are literally created as the investigation proceeds (Hussey and Hussey 1997).

These two paradigms, positivistic and phenomenological, also differ in terms of the type of research methods to be used and the type of data to be collected. Lee (1992) stated that quantitative and qualitative research methods are often considered to be based upon different ontological and epistemological assumptions, thereby shaping the aims of research enquiry. Quantitative research is often taken to mean a deductive, theory-testing and objective approach to the study of people where natural scientific methods are being used (Bryman and Bell 2003). Thus, it incorporates the practices and norms of positivism. Hussey and Hussey (1997) stated that positivist researchers seek exact measures and 'objective' research, conduct rigorous analysis and test hypotheses by carefully analysing numbers from those measures. They often use quantitative methods such as experiments



and surveys that normally use large samples and results are generalised for the whole population on the assumption that the samples are representative.

In contrast, the phenomenological paradigm is often characterised using qualitative methods such as participant observation and unstructured or semi-structured interviews. According to Mason (1996), qualitative research is grounded in a philosophical position that is broadly 'interpretivist' since it is concerned with how the social world is interpreted, understood, experienced or produced. In addition, a qualitative method is often taken to mean an inductive, theory-generating and subjective process which rejects the practices and norms of scientific methods in preference for an emphasis on the ways individuals interpret their social world (Bryman and Bell 2003).

Quantitative and qualitative methods form alternative, but not mutually exclusive, strategies for the researchers to choose for their research (Patton 1990). Several factors have to be considered before choosing the most appropriate research methods for a particular research. Factors such as the appropriateness of the chosen methods to the research objectives and research questions, the validity, reliability, generalisability of the data obtained as well as the availability of source materials, funding and time will influence the choice of research methods. Patton (1990) also suggested that rather than believing that one must choose to align themselves with one paradigm or the other, the selection of research methods must be based on the purpose of the study, the research questions and the resources available.

The literature review in Chapter 2 revealed that empirical research in the area of perceptions of auditor independence has been dominated by positivism with the majority of research following a quantitative approach. Survey research, a classic positivist research instrument, has been the most common form of research design used by researchers in this area. Two survey methods have been commonly used. They are: 1) the questionnaire survey (e.g. Beattie et al. 1999; Abu Bakar et al. 2005), and 2) the experimental survey (e.g. Shockley 1981; Colbert et al. 2008; Law 2008).

Chapter 2 also revealed that one study, Canning and Gwilliam (1999), used a combination of quantitative and qualitative methods. This method is also termed as ‘triangulation’ where two or more data collection methods are adopted within a research study (Bryman and Bell 2003). The use of triangulation enables researchers to interpret research findings correctly and overcome the potential bias of a single method approach (Hussey and Hussey 1997). This is because results from one method are cross-checked against the results from the other methods adopted (Bryman and Bell 2003). In Canning and Gwilliam (1999), survey questionnaires and semi-structured interviews were used to validate the findings of each other.

### **5.3 The Research Method Employed in this Study – the Postal Questionnaire Survey**

The present study examines the perceptions of audited financial statement users in Malaysia, mainly corporate lenders and professional investors, on several issues related to auditor independence. This study also attempts to establish relationships between the users’ demographic background (such as age, gender, levels of accounting education and prior experience in the accounting industry and respondent type) and their perceptions of auditor independence. Consequently, this research employed a quantitative methodology through a postal questionnaire survey in view of the following reasons. First, reflecting a positivist stance, this study requires a large number of sample respondents from all over Malaysia to enable the hypotheses testing. Hence, the use of a quantitative method is more appropriate and the use of a postal questionnaire permits the researcher to reach respondents in widely-dispersed geographical areas and can be administered in large quantities at the same time and at cheaper costs (Bryman and Bell 2003; Nachmias and Nachmias 1996; Oppenheim 1992).

Second, using qualitative methods such as interviews could also achieve the research objectives of the current study with opportunities to probe respondents to elaborate their answers. However, these methods are time consuming since only one interview can be conducted at a time and are more costly due to travelling costs. Third, the findings from

quantitative research such as a questionnaire survey allow for greater generalisation since data are collected from a larger sample size, more likely to be representative of the population.

This study ruled out the use of experimental survey designs using repeated measures and fixed effects since there are many factors within one variable (e.g. NAS – modes of NAS provision, types of NAS and the percentage of NAS fees to audit fees) that the current study intends to examine. Although this method provides an opportunity for the researcher to manipulate the independent variables (e.g. the provision of NAS and long audit tenure) in order to observe the effect on its dependent variable (auditor independence), it restricts the number of other factors that can be investigated in this study. If all factors are to be included, the questionnaire will become too long and respondents will become tired or bored while answering a long questionnaire (Beattie et al. 1999).

Basically, the postal questionnaire method was chosen because of its specific relevance to the nature of this study. It is designed to find out what a selected group of people do, think or feel (Hussey and Hussey 1997). It is also an effective approach in seeking opinions, attitudes and descriptions relating to the research issues (Ghauri and Gronhaug 2002). The survey method of collecting data is suited to the purpose of this study since its overall objective is to obtain the perceptions of corporate lenders and professional investors in Malaysia on several issues regarding auditor independence. In addition, Gwilliam (1987, p. 92) recommended that the use of questionnaires to obtain the current perceptions of auditor independence held by various interest groups could be a “more pragmatic approach” since the interpretation of the independence concept changes over time and thus “difficult to define in absolute terms”.

It has been suggested that interviewers’ characteristics such as race, gender and social background may lead to bias in the answers that respondents provide (Bryman and Bell 2003). Using a mail questionnaire, the interviewer or the researcher is absent when the survey is completed which avoids or lessens opportunities for bias (Oppenheim 1992; Neuman 2000; Bryman and Bell 2003). This condition upholds the positivist belief that the

process of research is value-free that the researcher does not influence the research subject. A postal questionnaire also offers greater anonymity (Nachmias and Nachmias 1996; Neuman 2000) which would encourage respondents to answer the questionnaire more honestly. In addition, this method is more convenient for respondents because they can complete the questionnaire when they want and at their own speed (Neuman 2000; Bryman and Bell 2003).

However, there are also several disadvantages of using a postal questionnaire. Bryman and Bell (2003) outlined a number of drawbacks to a postal questionnaire, namely there is no opportunity to assist respondents if they are having difficulty in answering the questions nor to probe respondents for more detailed explanations. Moreover, the researcher is not sure whether the right person has answered the questions. This method is also unsuitable for lengthy questions and for respondents with poor literacy and language problems. The risk of missing data is also greater when a questionnaire is used since there is no guarantee that all questions will be fully answered.

Bryman and Bell (2003) also pointed out that one of the most serious drawbacks of using a questionnaire is that it often results in low response rates, leading to non-response bias. Nachmias and Nachmias (1996) explained that the use of survey research has become a common method in many research fields and that the respondents in this study such as loan officers and professional investors may already have received a large quantity of surveys, potentially causing them to ignore some of those surveys that they receive. Their tight work schedule as professionals may also add to the reasons for disregarding the surveys. This situation is further complemented by another main limitation of the method: the respondents' participation on a voluntary basis, meaning that their willingness to take part depends on goodwill (Oppenheim 1992). A low response rate may also be due to other reasons such as lack of respondents' interest in the research topic or inherent ambiguities in the questions.

As the limitations of using a postal questionnaire were acknowledged, precautions were made to mitigate the problems discussed above. Section 5.9 provides detail of the approach

taken to increase the quality and quantity of responses. In addition, it was clearly stated in the covering letter as well as in the questionnaire that respondents could contact the researcher by phone or e-mail if there were any queries or further clarification required. Poor literacy and language problems of the respondents were viewed as insignificant since the respondents in this study, corporate loan officers and professional investors, can be categorised as professionals and hence knowledgeable with regard to the issues under study. Moreover, the questionnaire was presented in English in order to avoid misinterpretations concerning the translation of accounting and auditing terms into the national language. The English language is commonly used in matters related to accounting, auditing and corporate governance. This can be seen in the production of local accounting and auditing text books and documentation such as the MIA By-Laws and the MCCG.

The following section presents the questionnaire design process for the present research.

#### **5.4 Questionnaire Design**

According to Collis and Hussey (2009), a questionnaire design is concerned with the type of questions, their wording, the reliability and validity of the responses. In this study, the construction and validation of the questionnaire was primarily based on informal discussions and interviews, extensive reviews of existing auditor independence literature, audit regulations (SOX 2002 and IFAC), MIA By-Laws and similar questionnaire surveys that have been conducted in prior studies, either locally or abroad. From reviewing the literature, several research articles were found to be useful in developing the questionnaire, namely by Beattie et al. (1999), Canning and Gwilliam (1999), Imhoff (1978), Koh and Mahathevan (1993), Quick and Warming Rasmussen (2005; 2009), Sori et al. (2009) and Johnstone et al. (2001). As a result, five auditor independence issues were identified and formed the main structure of the questionnaire. These issues are: (i) long audit tenure, (ii) audit fee dependence on a single client, (iii) provision of non-audit services, (iv) ex-auditor employment with audit clients, and (v) the existence of an audit committee. Discussions were held with the researcher's supervisor, during which the draft questionnaires were

reviewed and commented upon several times. This step was significant in ensuring that all important issues were correctly included in the questionnaires. In addition, several Malaysian senior auditors were consulted in order to determine the appropriateness of the questions, particularly those related to the country's current audit regulations. A copy of the questionnaire and its covering letter are attached in Appendix 1.

As mentioned in the previous section, a low response rate is a major drawback to postal questionnaires. Following Bryman and Bell (2003) and Dillman (2007), the questions asked were short and uncomplicated. Given that there were five themes to be covered, the questionnaire was designed to be reasonable in length in order not to discourage respondents from completing it. The questionnaire consisted of 10 pages when set out on a single-sided A4 paper and was divided into six sections. To ensure that the questionnaire did not appear "unnecessarily bulky" (Bryman and Bell 2003, p. 145) and to give the impression of a professional approach, it was then decided to print the questionnaire into a double-sided booklet, with a differently-coloured cover in order to identify which group of recipients was targeted, the loan officers or professional investors. The logo of Cardiff University and that of the International Islamic University Malaysia, the research title, the researcher's name, the university affiliation and that of the research supervisor appeared on the cover page of the questionnaire. The inclusion of the universities' logos and research supervisor's brief details were believed to add credibility to the questionnaire and thus increase the respondents' trust in the research project.

According to Dillman et al. (2009), a closed-ended question is one of the most commonly used types of survey questions because it can measure gradations of a variety of opinions, attitudes, behaviour and attributes. Maintaining a positivist position, all questions in the questionnaire were closed-ended questions with ordinal scales (ranging from "strongly disagree" to "strongly agree") which permit the respondents to choose from predetermined answers. The choice of answers was in the form of a rating scale, which allowed a numerical value to be given to an opinion. It was also simple for the respondents to complete and was easy for the researcher to code and analyse (Hussey and Hussey 1997). Bryman and Bell (2003) further added that the advantages of using these types of questions

include easy identification of relationships between variables and easy comparisons between respondents. However, closed-ended questions may have inherent limitations resulting from a limited choice of answers. Respondents may lose spontaneity in responding, feel irritated or give false opinions since their preferred answers are not available (Bryman and Bell 2003). To overcome these limitations, one question has an answer category of 'Other - please state' to allow respondents to indicate what they mean by this category. Furthermore, a half-page space was provided on the last page of the questionnaire booklet for respondents to express their views on the issues under study. Given this situation, this research cannot be considered as adopting an entirely positivist position since elements of an interpretivist nature exist in the questionnaire. Nevertheless, it is acknowledged that open questions may have limited use in a self-completion questionnaire since a greater effort would be demanded from respondents who are likely to ignore the part that needs them to write extensively.

The types of questions used in the questionnaire were classified into two general categories; factual questions and questions designed to measure subjective states such as attitudes, opinions and feelings. Factual questions were designed to measure facts or objectively measureable events (Fowler 2002). The last section in the questionnaire, Section 6, (from questions 18 to 25), reflected factual questions. These questions attempted to obtain respondents' background information such as age, education and years of working experience. The rest of the questions in the questionnaire were included in order to obtain respondents' opinions or perceptions on such issues as whether auditor independence is affected if a longstanding relationship exists between auditors and their audit clients.

According to Dillman et al. (2009), ordinal scales can include as few as 2 points and as many as 10 or even 100 points. It is important to decide an appropriate scale length with enough categories since so many categories may cause confusion for respondents. In this study, a five-point Likert scale was used (ranging from "strongly disagree" to "strongly agree") following the recommendations of Dillman et al. (2009) that in general, scales should be limited to four or five categories. Since respondents can only hold a limited

number of categories in their head at once, providing fewer categories could “help reduce the cognitive complexity involved in providing a response” (Dillman et al. 2009, p. 137).

The first page of the questionnaire provided clear instructions for respondents to follow in completing the questionnaire. The confidentiality of responses was also emphasised to encourage respondents to give their honest opinions and information. In addition, a brief definition of auditor independence was also provided on this page. Bartlett (1993) stated that inconsistencies in prior findings may be contributed by failing to define independence or by defining it using non-specific terms such as integrity and objectivity, terms that are not widely understood by the general public. Thus, the definition used in this study was based on the definition by the MIA By-Laws with modifications to control for possible differences in respondents’ understanding of auditor independence (Canning and Gwilliam 1999). The term “unbiased” was used since “bias” is a widely understood term and does not have a meaning specific only to the accounting profession (Bartlett 1993).

Finally, the questionnaire was prepared in two versions: one for the corporate loan officers and one for the professional investors. Most of the questions within the two versions were commonly designed while questions related to whether the respondents’ lending or investing decisions were affected by the issues under study were designed specifically for each respondent group.

The following section provides discussion on the rationale for the questions in the questionnaire.

## **5.5 Questionnaire Rationale**

As discussed in Chapter 4, the research questions guide the construction of the questionnaire. Based on the research questions, the questionnaire was developed and divided into six sections.

### **Section 1: Long Audit Tenure**



Section 1 addresses Research Question 1:

*What are the perceptions of loan officers and professional investors regarding the impact on auditor independence when there is a lengthy relationship between audit firms and their audit clients?*

#### Question 1

This question seeks to explore respondents' views on issues surrounding a lengthy auditor-client relationship and whether these issues affect their perceptions of auditor independence. The first three statements in this question determine whether the respondents perceive a lengthy relationship as threatening the auditor's independence, affect their confidence in the auditor's independence and whether they consider audit tenure in their lending or investing decisions. As justified in the previous chapter, finding answers to these statements is crucial since results in prior studies have been inconsistent, thus more recent research findings are needed to support the arguments for or against auditor rotation. This part of Question 1 addresses Hypothesis 1a which attempts to test whether lengthy audit tenure affects respondents' perceptions of auditor independence.

The second part of Question 1 attempts to obtain respondents' views on the current system of audit partner rotation. This question is important in helping to determine whether the current practice is perceived by Malaysian loan officers and professional investors as sufficient to safeguard auditor independence or should an audit firm rotation policy be implemented to replace the current policy. Mandatory audit firm rotation has been argued in the literature as the main safeguard against the threat arising from a lengthy auditor-client relationship. However, opponents of mandatory audit firm rotation argue that the likely benefits of rotating audit firms outweigh the increase costs for the audit firm, the client and the public as questionable (Fearnley and Beattie 2002). This part of Question 1 addresses Hypothesis 1b and Hypothesis 1c.

#### Question 2

Question 2 requires respondents to indicate their belief in the number of years, after which, an audit partner should rotate (within the same audit firm). The current policy is deemed

insufficient to safeguard independence if respondents tick boxes in the less than 5-7 years categories. Other choices are also provided and the maximum is a period of more than 25 years. Kaplan and Mauldin (2008) claimed that 25 years is clear evidence of a long-term relationship between an audit firm and a client company. A choice of “Never” is also provided for respondents who entirely oppose the implementation of partner rotation.

### Question 3

This question attempts to explore respondents’ opinions on the number of years that audit firms should rotate if the system of firm rotation were to be implemented in Malaysia. Several choices of answers are provided and the maximum is a period of more than 25 years, similar to Question 2. A choice of “Never” is also provided for respondents who oppose such implementation.

## **Section 2: An Auditors Economics Dependence on a Single Audit Client.**

Section 2 addresses Research Question 2:

*What are the perceptions of loan officers and professional investors regarding the impact on auditor independence when audit firms and audit partners are financially dependent on the audit fees they derive from a single audit client?*

### Question 4

This question determines whether loan officers and professional investors view economic dependence by an auditor upon a single audit client as impairing auditor independence. It also seeks to gather information on whether the two respondent groups consider the information on audit fees in their investing and lending decisions. It is assumed that, in reality, they do not consider this information at all in the course of their work, and that economic-dependence-led threats to auditor independence are simply a matter of perception. One of the statements on this question deals with the perceptions of an individual audit partner’s ability to remain independent when the total fees generated from his/her audit client represent a large proportion of his/her income. The IFAC and MIA By-Laws have expressed concerns that a self-interest threat may be created when fees generated from a single client exceed 15% of auditors’ total income for two consecutive

years. Thus, the views of loan officers and investors are also sought to determine whether they also share similar concerns. Question 4 deals with Hypothesis 2a and Hypothesis 2b; that an audit firm's and an audit partner's dependence on income from a single audit client will have no effect on loan officers' and professional investors' perceptions of auditor independence respectively.

#### Question 5

This question attempts to gather respondents' views as to whether a 15% limit on the firm's total income as the maximum amounts that an audit firm may receive from any one client is a sufficient safeguard to auditor independence. The respondents are also required to state the increased or reduced percentage limit if they "agree" and "strongly agree" that the 15% rate is not a sufficient mechanism to protect independence. This question also addresses the suggestion made by Shockley (1980) who stressed the need to investigate the point at which users consider a factor as negatively affecting independence since they may recognise that the factor may impair independence but still accept it as part of the audit function.

### **Section 3: The Provision of NAS to Audit Clients**

Section 3 addresses Research Question 3:

*What are the perceptions of loan officers and professional investors regarding the impact on auditor independence when auditors provide NAS to existing audit clients?*

#### Question 6

This question determines whether the provision of NAS to audit clients affects respondents' perceptions of auditor independence and their investing and financing decisions. In addition, the question seeks to explore the respondents' views on the potential impact of providing NAS in four situations using the arguments outlined in the literature. As mentioned in the previous chapter, this question is important since findings in prior research have been inconsistent, more recent research needs to be conducted to resolve the debate over the provision of NAS. This question also addresses Hypothesis 3a; that the

provision of NAS by audit firms to audit clients will not affect loan officers' and professional investors' perceptions of auditor independence.

#### Question 7

This question determines whether modes of NAS provision affect the respondents' perceptions of auditor independence. Four modes of NAS provision are given: 1) when NAS are provided by the same personnel involved in an audit, 2) when NAS are provided by personnel from a separate department, 3) when NAS are provided by a separate entity where the auditors have an interest, and 4) when NAS are provided by the same personnel involved in an audit, but full disclosures are made in the clients' financial statements. The respondents are required to indicate their level of agreement as to whether auditor independence would be affected if NAS were provided in each mode of NAS provision. Prior studies found that the independence concerns decreased when NAS were provided by different personnel than by the staff involved in the audit (e.g. Canning and Gwilliam 1999; Swanger and Chewning 2001). Question 7 addresses Hypothesis 3b that the separation of staff for audit and NAS will not affect loan officers' and professional investors' perceptions of auditor independence.

#### Question 8

This question seeks the respondents' opinions on whether a maximum percentage of non-audit fees to total fees should be prescribed by the accounting regulator to safeguard auditors from relying too much on income from NAS. This question is based on the argument that the relative size of NAS fees (as a percentage of audit fees or total fees) could influence auditor independence (Pany and Reckers 1983; Beatie et al. 1999). This question is important because accounting regulators such as the IFAC and MIA are silent about the proportion of NAS fees to total fees while the appearance of auditor independence could be damaged if auditors were to receive higher NAS fees than audit fees. It is in the interests of this current study that this issue is pursued. The total fees measure is used to investigate auditor independence since it captures the explicit bond between the auditors and their clients (Ashbaugh et al. 2003).

### Question 9

This question determines whether the different types of NAS would threaten auditor independence as perceived by professional investors and bank lenders. A list of 13 types of NAS is provided based on the literature review and MIA By-Laws. This question is important since different types of NAS would have different responses to the provision of NAS (Schneider 2006) and thus would affect auditor independence in different ways. Kinney et al. (2004) found evidence that support the view that taxation services to audit clients are not a threat to independence. However, the results in the archival study by Colbert et al. (2008) and Quick and Warming-Rasmussen (2009) revealed that the provision of tax services negatively affected financial statement users' perceptions of auditor independence and their lending and investment decisions. Further evidence needs to be gathered in order to confirm whether a problem exists in perceptions of different types of NAS and auditor independence. The provision of legal services was not included in the list of NAS since in Malaysia, only those admitted as advocates and solicitors pursuant to the country's Legal Profession Act 1976 are allowed to provide legal services. Due to this condition, the MIA does not incorporate the provisions of legal services in the By-Laws as one of the types of NAS that has the potential to impair auditor independence. This question addresses Hypothesis 3c; that the type of NAS provided to audit clients has no impact on loan officers and professional investors' perceptions of auditor independence.

### **Section 4: Ex-Auditor Employment with an Audit Client**

This section addresses Research Question 4:

*What are the perceptions of loan officers and professional investors regarding the impact on auditor independence when auditors accept employment with an audit client?*

### Questions 10 & 11

Question 10 explores respondents' views on the practice of auditors seeking employment with an audit client in Malaysia and whether this issue affects the respondents' lending and investing decisions. Question 11 determines the extent of their concerns in two situations; i) auditors' prior position in an audit firm, and ii) auditors' subsequent position in the client company (whether or not the role involves the preparations of company accounts), and

whether these situations would cause impairment to auditor independence. As discussed in the rationale for Research Question 4 in Chapter 4, finding answers to these questions is important since limited research exists on the effect of ex-auditors' employment with audit clients. Questions 10 and 11 also address Hypotheses 4a, 4b and 4c; that neither the practice of ex-auditors seeking employment with their audit clients nor the ex-auditors' prior supervisory position in the audit firm and their subsequent position at a client company, will affect loan officers' and professional investors' perceptions regarding auditor independence.

### Question 12

In the previous chapter, it is explained that audit firms are not allowed to continue auditing their public listed client when their audit partner joins the client and holds a significant position, unless the cooling-off period requirement has been observed. This question determines respondents' views on the current practice of cooling-off period of two years. The respondents are required to state the extent of their agreement that the 2-year cooling-off period is sufficient to safeguard the remaining auditors' independence. The question also required those who answer 'disagree' or 'strongly disagree' with the sufficiency of the 2-year cooling-off period to state how long they believe the cooling-off period should be. Several choices of answers are given between a minimum period of six months and a maximum of more than three years based on Imhoff (1978). A choice of 'Other (Please state)' is also given for respondents who feel that another period (between one month and three years, apart from the choices of answers given) is more appropriate as a 'cooling-off' period.

## **Section 5: Safeguards to Auditor Independence**

Section 5 addresses Research Questions 5 and 6:

*RQ5 - What are the perceptions of loan officers and professional investors regarding the impact on auditor independence when an audit committee exists in a client company?*

*RQ6 - What are the perceptions of loan officers and professional investors regarding the impact on auditor independence when other safeguards are in place?*

### Question 13

This question determines whether respondents agree that the existence of an audit committee may safeguard auditor independence. Prior archival studies provide much evidence that a more independent, expert and active audit committee is associated with higher quality financial reporting and auditing (Klein 2002; Beasley et al. 2000; Abbott et al. 2004; Abbott and Parker 2000). However, most perceptual studies only examine the existence of audit committees in general and the impact on auditor independence. Given that the current roles of an audit committee have been enhanced, it is crucial to determine whether the roles would enhance auditor independence from the perspective of loan officers and professional investors in Malaysia. This question addresses Research Question 5 and deals with Hypotheses 5a, 5b, 5c, 5d, 5e, 5f and 5g.

### Question 14

This question extends Question 13 as it requires respondents to indicate whether or not they consider the information on an audit committee before they lend money to (for loan officers) or invest in (for professional investors) a company. This question determines whether their perceptions about the existence of an active, independent and expert audit committee and its other roles in reality influence their action as bank lenders and investors.

### Question 15

This question aims to obtain respondents' opinions on the issues of potential safeguards to auditor independence relating to the provision of NAS to audit clients, employment with audit clients and audit staff rotation. Their views are also sought on regulations such as disclosures on NAS, peer review programs, inspections of the audit documents of public listed companies, and investigations and disciplinary actions imposed on auditors who fail to comply with audit and ethical standards. This question addresses Research Question 6.

### Question 16

This question attempts to solicit respondents' opinions on whether auditors of public listed companies in Malaysia should be regulated by the such accounting profession as the MIA or the AOB. The Board was recently established in Malaysia and is responsible for

overseeing the auditors of public interest entities and protecting investors' interests by promoting confidence in the credibility of audited financial statements (AOB 2010). This question is important in determining whether the respondents would still be in favour of a self-regulating accounting profession or concur with the regulators' decision to separate the auditors of public listed companies from the accounting profession. This question also addresses Research Question 6 as shown above.

#### Question 17

This question asks respondents to determine how important they consider an audit report to be, in making lending and investing decisions. This question is important, since it reflects how the respondents view the question of auditor independence (Firth 1980). This notion has been supported by Abu Bakar et al. (2005) and Gul and Teoh (1984). If respondents perceived the audit report as very important in making decisions, this indicates "that they have confidence (regardless of the degree of confidence) in the credibility of the accounting profession" (Abu Bakar et al. 2005, p.813).

#### **Section 6 – Some Information about You**

This section addresses Research Question 7:

*Is there any relationship between loan officers' and professional investors' background variables (such as accounting education, prior working experience as auditors or accountants in industry, age and gender) and their perceptions of auditor independence?*

#### Question 18- 25

This section gathers factual information on respondents' profiles such as age, gender, current job position, years of experience, academic qualifications and whether they have prior working experience as auditors or accountants in industry. These questions assist the researcher in ensuring the quality of answers from the postal survey. Essentially, it is assumed that respondents who held senior positions with lengthy working experience will provide more reliable opinions than those in junior positions or with limited working experience. Those questions related to accounting education, prior working experience as



an auditor or accountant in industry, age and gender (Questions 18, 19, 24 and 25) address Hypotheses 6, 7, 8 and 9.

## **5.6 Research Ethics**

The Ethics Committee is responsible for approving on ethical grounds all research being undertaken with Cardiff Business School. The ethical guidelines states that approval must be sought where research involves participants from outside the university (i.e. bank loan officers) and children under 16 years of age. The current study had to follow these ethical guidelines by submitting a formal application to the Ethics Committee before the questionnaire survey could be sent to the respondents.

According to Bryman and Bell (2003), ethical research should consider whether:

- There is harm to participants,
- There is a lacked of informed consent,
- There is an invasion of privacy, and
- Deception is involved.

In order for the Ethics Committee to assess the ethical aspects of the research, the ethical approval form requires information about the research topic and a brief description of each step in the execution of the research including how data will be collected (i.e. through surveys or interviews). The sample selection must be described in a way that the Committee can evaluate who the respondents will be and what special considerations may be necessary. The application form also requires a description of how consent will be obtained. In the covering letter that accompanied the questionnaire, respondents were informed about the objectives of the study and assured that their responses to the questionnaire would be treated as confidential. Respondents' consent was implied by their responses. In addition, respondents were also provided with the researcher's and the primary supervisor's contact details to enable respondents to discuss any concerns

associated with their participation. A copy of the approved research ethics application form is attached in Appendix 2.

The next section will discuss the importance of pilot testing of the questionnaire.

## **5.7 Pilot Testing of the Questionnaire**

Prior to sending the actual questionnaire to corporate loan officers and professional investors in Malaysia, it was thoroughly pre-tested to identify and rectify any problems that were not detected during the design stage. Problems such as unclear instructions, difficulty in answering the questions, inconsistent language and typing errors may lead to an unwillingness of respondents to complete the questionnaire and result in low response rates. Pilot testing of the questionnaire ensures that it adequately covers the issues under study, relevant to the targeted respondents and can be easily completed, thus increasing the likelihood of a good response rate. In addition, since there will not be an interviewer present during the actual survey process, a pilot test is crucial to clear up any confusion (Bryman and Bell 2003).

In this study, prior to actual distribution, five copies of the draft questionnaire were circulated to academic staff in the Accounting Department of Economics and Management Faculty at the International Islamic University of Malaysia and three copies were sent to the research students of the Accounting and Finance Section of Cardiff Business School. Some of the comments and suggestions received were found to be useful and were incorporated into the draft questionnaire. Hussey and Hussey (1997, p. 163) further suggested that a pilot test should be carried out on “people who are similar to those in your sample”. The revised questionnaire was then distributed to four loan officers and two financial analysts, whose responses reflected those of the actual respondent groups in this study. In general, there were no major revisions to the questionnaire and after a few minor changes were made, the final questionnaire was sent out starting from the final week of July to the first week of October 2010.

## **5.8 Sample Selection**

The population selected for this current study consists of financial statement users mainly corporate loan officers and professional investors in Malaysia. The literature review revealed that loan officers and investors are among those most likely to use audited financial statements in making business decisions and thus most likely to appreciate auditor independence (Firth 1980). These respondents also represent more active stock market participants than would a random sample of investors (Imhoff 1978). Their assumed knowledge of financial reporting procedures, as well as their assumed investment decision-making activity, were the criteria for their selection as representatives among financial statement users. Loan officers were also selected because they are relatively sophisticated financial statement users who could understand the importance of auditor independence (Gul 1991). Even though the perceptions of loan officers have been examined in prior Malaysian studies, such studies are now either dated (Gul and Yap 1984) or only given to examining the issue of independence in general terms (Abu Bakat et al. 2005). The perceptions of loan officers may have changed significantly especially after the collapse of Enron and the recent accounting scandals involving Malaysian companies. In this study, only corporate loan officers were selected, since they are considered most likely to deal with listed companies' loan applications. Thus, it was possible to locate the target respondents mainly in the headquarters of their companies.

Professional investors were also chosen since they are representative of a reasonable investor whose investing decisions may be affected if they perceive an independence problem (Mauldin 2003). Ku Ismail (2003) stated that investors' decisions are greatly influenced by the opinions held by professional investors. Moreover, independence rules and regulations are designed in order to promote investor confidence in the financial statements of public companies, thus making professional investors' perceptions of independence highly relevant. In addition, investor perceptions of auditor independence in developing countries may be different when compared to those of the developed countries. Since no Malaysian study has examined professional investors' perceptions of auditor independence, this study intends to fill that gap. In this study, professional investors were

represented by analysts and fund managers, both of whom have been identified as the most important professional investor groups in the capital market (Moizer and Arnold 1984).

Other groups of financial statement users such as company managers were not selected since they represent the preparers' group. Quick and Warming-Rasmussen (2005) argued that independence perceptions of auditors are less relevant because they are the ones who audit the financial statements and they themselves do not see any impairment in their independence. In their study, Quick and Warming-Rasmussen found that the majority of financial statement users perceived auditor independence to be impaired when an auditor provides NAS, whereas 86% of auditors failed to see that such services may affect their ability to remain independent. Cheung and Hay (2004) also claimed that not much input from those who rely on the financial reports has been considered in dealing with the independence issues and the setting of the rules. Since it is the users of financial statements that need to be reassured about auditor independence, their perceptions are important and more relevant in determining public confidence in the financial statements of public companies.

As at 1<sup>st</sup> January 2010, there were nine commercial (or conventional) banks and eleven Islamic banks in existence<sup>18</sup>. Both commercial and Islamic banks were included since the nature of their businesses is more or less the same, in that they both include the provision of corporate lending services (Abu Bakar et al. 2005). The only difference is that the operation of the Islamic banks is based on *Shariah* or Islamic law, while that of the commercial banks is based on secular principles which are not grounded in any religious laws or guidelines. Two Islamic banks were pure Islamic banks which were not parts or subsidiaries of any commercial banking groups. The remaining Islamic banks were previously Islamic banking windows of their respective commercial banks that offered Islamic banking products and shared infrastructures, including staff and branches. In most of the commercial banking groups, where a corporate loan department is concerned, loan officers of the groups process both conventional and Islamic financing applications.

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<sup>18</sup> Following the Central Bank of Malaysia's lists of financial institutions, this study referred conventional banks as commercial banks.

Nevertheless, further investigation revealed that six Islamic banks (including the two pure Islamic banks) have their own corporate banking department. Thus, the initial composition of banks in this study consisted of nine commercial banks and six Islamic banks. Subsequently, two of the commercial banks refused to participate in this study, citing their banks' privacy policy. The final bank population comprised seven commercial banks and six Islamic banks.

The total population of corporate loan officers was unknown since bank officials were not allowed to disclose the total number of corporate loan officers they employed. To research loan officers' perceptions, volunteer bank lending officers were used (similar to Gul 1989). The Corporate Affairs Department of six commercial banking groups, the Head of the Corporate Loan Department of the remaining banking group and all Islamic banks were contacted, to ask for assistance to distribute questionnaires to the relevant staff in their department. The staff representatives in each banking group and in one Islamic bank were willing to accept 20 sets of questionnaires while 10 sets of questionnaires were sent to the remaining Islamic banks for distribution.

With regard to professional investors, Ku Ismail and Chandler (2005) stated that professional investors can be identified in stock-broking firms, fund management companies, investment advisory firms, unit trust fund companies and large public fund organisations. As of 1<sup>st</sup> January 2010, there were 34 stock-broking companies (which consisted of 15 investment banks and 19 non-investment banks) with 160 branches, 41 unit trust fund companies and five large public fund organisations. Similar to bank loan officers, the number of analysts and fund managers in each organisation is unknown. The sampling approach employed by Ku Ismail (2003) was replicated in this study. Ku Ismail (2003) sent three sets of questionnaires with covering letters to the head of the research department and the head of fund managers in her study of professional investors' perceptions of the usefulness of quarterly financial reporting in Malaysia. This study mailed five sets of questionnaires to the head of research in 15 investment banks and three sets of questionnaires were sent to the head of research in 19 non-investment banks, the head of fund managers in 41 unit trust funds and the head of fund managers in four large

public fund organisations. One of the investment banks subsequently returned the five questionnaires to the researcher explaining that the bank did not have any research department nor analysts. Thus, the total number of investment banks in the sample was reduced to 14. While Ku Ismail (2003) also sent three sets of questionnaire to branches, this study did not send any. This decision was based on some head of analysts' remarks that branches only focus on sales, marketing and customer service. It is assumed that sending five sets of questionnaires to large organisations such as investment banks and three sets of questionnaires to the remaining organisations was reasonable. Table 5.1 summarises the data on the questionnaires for the loan officers and professional investors respectively.

## **5.9 Administration of the Questionnaire**

As mentioned previously, a major drawback to a postal questionnaire is a potentially poor response rate. Section 5.6 discussed how pilot testing could minimise the problem of a low response rate. In addition, several other steps were also taken to ensure that the quantity of responses would be maximised.

First, a covering letter was attached to the questionnaire, briefly describing who the researcher was and stressing the objectives of the study and the importance of respondents' opinions in ensuring the success of the research. The covering letters were printed on the letterhead of the Economics and Management Sciences Faculty, International Islamic University Malaysia, the university to which the researcher is attached, and signed by the researcher. Printing the covering letters on the university's letterhead further ensured the authenticity and credibility of the research project. The covering letters were personalised by addressing them to the Head of the Corporate Loan Department in each bank, the Head of the Research Departments of the investment banks, the non-investment banks and the stock broking companies and the Head of Fund Managers in the unit trust fund companies and large public fund organisations. This personalised information was obtained via the organisations' website and checked by telephone to ensure that the questionnaire was addressed to the right person.

Second, the confidentiality of the respondents' answers was also assured and this was clearly stated in the covering letter as well as on the first page of the questionnaire. Oppenheim (1992) emphasised that all survey data must be treated as confidential, in the sense that only the researcher will have access to them. A confidentiality statement ensures the respondents that no information will be published about identifiable persons or organisations without their permission. The assurance of complete anonymity may also increase response rates but it then becomes impossible for the researcher to send out reminders to non-respondents (Oppenheim 1992). In this study, the respondents were not completely anonymous since they can be identified by their positions, organisations and addresses. To provide greater anonymity, the researcher used a coding system where the respondents were identified by a code number that was printed on the reply envelope that accompanied the survey booklet.

Third, the postal questionnaire was accompanied by a stamped, self-addressed reply envelope. The presence of the reply envelope contributes to the convenience of person responding (Dillman 2007) since it is unreasonable to expect the respondents to take any additional effort to locate, address and stamp the envelopes (Nachmias and Nachmias 1996). The stamps used in this study were also 'real' stamps rather than a business reply envelope since it is suggested that "a 'real' stamp indicates trust and will increase response rates" (Oppenheim 1992, p. 105).

Fourth, a personal 'thank you' message was also inserted in the covering letter and at the end of the questionnaire thanking respondents for their effort and time in completing the questionnaire. Finally, the respondents were offered a summarised analysis of responses to the survey as an incentive to complete and return the questionnaire.

As mentioned in the previous subsection, the questionnaire was first distributed in the final week of July 2010. Since this study dealt with many organisations, the mailings of the initial questionnaires continued until the second week of August 2010. The mailing date of each questionnaire was recorded. After four weeks in circulation, only 34 responses were

received which constituted a response rate of only 7%. This was considered a poor response rate, which paucity might have been attributable to the period during which the questionnaires were sent coincided with the fasting month of *Ramadan*. During this month, most Malaysian companies with a Muslim majority work through their lunch hour, allowing officers to leave the office earlier. This month could be seen as a busy month especially for Muslim officers. Given this situation, performing a follow-up procedure was crucial.

The first follow-up letters were sent to those respondents who had not responded to the initial mailing immediately after the *Eid* holidays which were in the second week of September 2010. The questionnaire booklet and a post-paid reply envelope were also included reflecting the fact that more than one month had passed and that the original questionnaire booklets may have been misplaced or discarded by the respondents. In addition, random follow-up phone calls were also made in order to increase the response rates. The results of the first follow-up mailings can be seen in Table 5.1 which indicate an increase in response rates by 17%; an additional 81 responses were received. The second follow-up letters were sent to the non-respondents in the second week of October 2010; four weeks after the first follow-up was conducted.

<b>Table 5.1: Analysis of Responses by Respondents Category</b>					
<b>Category</b>	<b>Total Questionnaires Issued</b>	<b>Initial Mailing - Usable Responses (%)</b>	<b>1<sup>st</sup> Follow Up - Usable Responses (%)</b>	<b>2<sup>nd</sup> Follow Up - Usable Responses (%)</b>	<b>Total Usable Responses (%)</b>
<b>Corporate Loan Officers:</b>	<b>210</b>	<b>20 (10%)</b>	<b>42 (20%)</b>	<b>48 (23%)</b>	<b>110 (52%)</b>
- Commercial banks	140	13	25	33	71 (51%)
- Islamic banks	70	7	17	15	39 (56%)
<b>Professional Investors:</b>	<b>262</b>	<b>14 (5%)</b>	<b>39 (15%)</b>	<b>14 (5%)</b>	<b>67 (25%)</b>
- Investment banks	70	7	13	5	25 (36%)
- Non-investment banks	57	3	15	-	18 (32%)
- Fund management company	123	4	7	3	14 (11%)
- Public funds organisations	12	-	4	6	10 (83%)
<b>TOTAL</b>	<b>472</b>	<b>34 (7%)</b>	<b>81 (17%)</b>	<b>62 (13%)</b>	<b>177 (38%)</b>



### **5.10 Testing for the Non-Response Bias**

The non-response bias in a mail questionnaire occurs when the responses of those who did not respond are significantly different from those who did respond. As a result, the findings based only on those who respond are biased in some way. Hussey and Hussey (1997) stated that the available data might not be representative of the population since it may be biased due to incomplete data collection. Based on Table 5.1, after the first follow-up, the overall response in this study was 24%. This means that the non-response rate was 76%. If the perceptions of the non-response group did indeed differ significantly from the response group, the findings in this study might be considered unreliable and invalid.

Wallace and Mellor (1988) cited in Hussey and Hussey (1997), recommended a technique to detect non-response bias by comparing the responses of late respondents to the responses of early respondents. This study followed the above technique by comparing the responses of the last 20 questionnaires received to those of the first 20 questionnaires received. The Mann-Whitney U test was used to examine any difference in the perceptions between the two groups. This technique was used to test the non-response bias in the perceptions of both types of respondents in this study: loan officers and professional investors.

The results of the Mann-Whitney U test indicated no significant difference between the early and the late responses in the loan officers group. Out of 82 questionnaire items, late respondents from the professional investors group differed significantly from early respondents in the same group in seven items only. Therefore, it might be concluded that the non-response bias does not appear to be a substantial problem in this study.

### **5.11 Testing for Self-Selection Bias**

The self-selection bias in a survey questionnaire often results when survey respondents are allowed to decide entirely for themselves whether or not they want to participate in a

survey (Olsen 2011). It originates from the fact that people are more likely to respond to questionnaires if they see items which interest them such as: they may be affected by the items asked or they may be attracted by the incentives offered for participating (Eysenbach and Wyatt 2002). Since people who respond almost certainly have different characteristics than those who do not, the results are likely to be biased; those who choose to participate will not well represent the entire target population (Olsen 2011). This type of selection bias is considered more serious than the bias arising from the non-representative among the population because the researcher has to try to compensate for many possible unknown factors and has little opportunity to interpret their results accordingly (Eysenbach and Wyatt 2002).

There is no specific approach to address the problem with self-selection bias. However, in this study, several efforts were taken to address the existence of self-selection bias. First, the sample was divided into two groups: a control group consisting of respondents with prior experience as auditors and an experimental group comprising those without auditing experience. It was expected that those with prior experience as auditors would be more interested in answering the questionnaire survey than those without prior audit experience. Responses from both groups (loan officers and professional investors) were tested using the Mann-Whitney U test. The results indicated no significant difference in the responses between the two groups. In the second attempt to test for the self-selection bias, the sample was divided into another two groups: a control group that consisted of those with five years and more working experience, and an experimental group that comprised of those with less than five years' experience. The 5-year experience was used as a benchmark as it was expected that respondents with at least five years' experience may have higher skills and experience in their profession than those with less than five years' experience. The Mann-Whitney test results revealed no significant difference between the responses of the two groups. Based on the results of these two tests, it can be concluded that the effect of self-selection bias was minimal in this study.

## 5.12 Reliability of the Questionnaire Data

Prior to any statistical analysis, it is important to ensure that data are reliable. Hussey and Hussey (1997) stated that research findings could be said to be reliable if the same results are generated when the research is repeated. Many methods have been utilised to assess data reliability such as the test and re-test method, the split-halves method, the internal consistency method and the Cronbach alpha coefficient (Hussey and Hussey 1997; Bryman and Bell 2003). The Cronbach alpha coefficient is one of the most commonly used indicators of the internal consistency of responses. Internal consistency describes the extent to which all the items in a test or a scale measure the same concept or construct (Tavakol and Dennick 2011). The resulting coefficient ranges from 0 to 1, where 0 indicates ‘no internal reliability’ and 1 indicates “perfect internal reliability” (Bryman and Bell 2003, p. 77). The reliability of the research instruments can be measured across all questions or on sub-groups of questions (Saunders et al. 2000). As a rule of thumb, questionnaires need to score 0.7 or above (Pallant 2003). However, the Cronbach alpha coefficient is quite sensitive to the number of items in the scale. Thus, it is common to find quite low Cronbach values for scales with less than ten items (Pallant 2001).

In the current study, the Cronbach alpha coefficients, which were generated using the SPSS statistical software, for measuring the questionnaire (across all questions) for the loan officer, professional investor and overall datasets were above 0.7.<sup>19</sup> The reliability of the sub-groups of questions that measure the scale for each factor affecting auditor independence will be discussed in detail in Chapter 6.

The next section will discuss the statistical tools that were employed in this study.

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<sup>19</sup> Cortina (1993) provided the formula for calculating the Cronbach alpha coefficient as follows:

$$\frac{N^2 \times M(\text{COV})}{\text{SUM}(\text{VAR/COV})}$$

where:  $N^2$  is the square of the number of items in a scale,  $M(\text{COV})$  is the mean inter-item covariance and  $\text{SUM}(\text{VAR/COV})$  equals the sum of all of the elements in the variance/covariance matrix.

### **5.13 Statistical Tools**

In analysing the questionnaire, standard statistical software, SPSS version 18, was used. Descriptive analysis of the results from the questionnaire was conducted to derive the frequency, means and distributions of responses. The means and percentage distributions generated would permit the ranking of variables investigated and the identification of trends.

Two types of statistical technique can be used to further analyse the data, namely: parametric and non-parametric tests. Parametric tests are appropriate for use and considered as the most powerful test when the following assumptions are met (Siegel and Castellan 1988):

1. The observations must be independent i.e. the selection of any one case from the population in the sample must not bias the chances of any other case for inclusion.
2. The observations must be drawn from normally distributed populations.
3. For analyses concerning two groups, the populations must have the same variance.
4. The variable must have been measured in at least an interval case.

Non-parametric tests, on the other hand, do not have stringent requirements and do not make assumptions about the underlying population distribution (Pallant 2001). These tests are more suitable for use when data is measured on nominal and ordinal scales, when samples are small and when data does not meet the stringent assumptions of the parametric techniques (Pallant 2001, Siegel and Castellan 1988). In order to decide which types of statistical techniques to be used, the normality of the distribution of responses to the questionnaire survey was assessed.

The normality of the distribution of survey responses can be assessed to some extent by obtaining skewness and kurtosis values (Pallant 2001). The skewness value provides an indication of the symmetry of the distribution whereas kurtosis provides information about the 'peakness' of the distribution. A perfectly normal distribution where the skewness and kurtosis values are zero is an uncommon occurrence in the social sciences. In this study,

the distribution of responses for both samples of respondents is reasonably skewed with negative skews (scores clustered to the right at the high value) for most statements. A positive skew indicates a clustering of responses at the low end of the distribution.

The normality of the distribution of survey responses can also be assessed by examining the Kolmogorov-Smirnov statistic (Pallant 2001). A non-significant result (Sig. value of more than 0.05) indicates normality. In this study, the results were significant for all statements, suggesting violation of the assumption of normality. The study also visually examined the shape of the distribution of responses using histograms. Nevertheless, the responses also appeared non-normally distributed.

This study also attempted to normalise the distribution of responses by transforming the data, as suggested by Pallant (2001), using the square root (for distribution of responses that were positively skewed) and using the reflect and square root functions (for distribution of responses that were negatively skewed). Decisions on the types of transformation were made based on the shapes of the distribution of responses generated earlier using the histograms. Nevertheless, the results of the transformations of data using the approaches mentioned above still did not improve the normality of the distribution of responses.

Since the normality tests indicated that the distribution of responses was non-normal and since most of the scales used to measure the variables in this study are nominal and ordinal in nature, the main statistical technique that was used in this part of the study included non-parametric testing. The following were the non-parametric techniques used in this study:

- 1) **The One-sample Wilcoxon signed rank test (WSRT)** was used to determine whether respondents' median response for each statement in the questionnaire differs significantly from '3' (the respondents were neutral with regard to the statement). A significant difference in the sample's median and '3' may indicate the tendency of the respondents to either agree or disagree with the statement.

- 2) **The Wilcoxon matched-pairs signed rank test** was conducted to compare respondents' perceptions under two different conditions (i.e. when the same audit personnel provides NAS to audit clients and when different personnel provide NAS to audit clients)
- 3) **The Friedman test** allows the study to compare respondents' perceptions under more than two different conditions (i.e. when NAS is provided to audit clients by: i) the same audit personnel, ii) personnel from a separate department within the audit firm, iii) a separate firm where the auditors have an interest, and iv) the same personnel involved in an audit, but full disclosures are made in the clients' financial statements).
- 4) **The Mann-Whitney U test** was used to measure the consensus in perceptions between two independent groups (i.e. those with accounting and without accounting qualifications)
- 5) **The Kruskal-Wallis test** was conducted to determine whether there is any significant difference in responses among three or more independent groups. This test was used in this study to ascertain whether the age of respondents would have a significant impact on their perceptions of auditor independence. There were four age groups of respondents in this study, specifically: less than 30 years, 31-40 years, 41-50 years and 51-60 years.

#### **5.13.1 Scales Development and Composite Scores**

In this study, five scales that could measure the five factors that have the potential to affect respondents' perceptions of auditor independence could also be developed based on the existing questionnaire items. This is based on Dart and Chandler (forthcoming) as they measured respondents' overall perceptions by constructing a scale for client employment of an auditor. In their study, the statements related to whether the practice of auditors seeking employment with audit clients affected respondents' perceptions, confidence and investing decisions were included in the scale. Dart and Chandler, however, did not explain

how the items were derived or if they had been pre-tested to assess content validity in any way.<sup>20</sup>

DeVellis (2003) provided a set of specific guidelines that could be used in developing measurement scales for each factor under study. Steps 1 to 4 relate to item development or the generation of individual items or statements for each factor. Hinkin (1995) stated that the generation of items may be the most important part in developing sound measures. Hinkin also pointed out one concern with regard to item generation that is the possibility that some of the items generated may lack content validity. Hinkin suggested that a necessary pre-requisite for new measures would be establishing a clear link between items and their theoretical domain. Steps 5 and 6 involve scales development or the manner in which items or statements are combined to form a scale. These include making decision on scaling of items and sample size needed to appropriately conduct tests of statistical significance. A potential drawback of small sample size is that the development sample may not represent the population for which the scale is intended (DeVellis 2003). Finally, steps 7 and 8 involve scales evaluation or the psychometric examination of the new measure. These steps include dealing with reverse scoring items, validity, reliability and the length of scales. As mentioned in Section 5.4, the validity of the questionnaire items in this study were primarily based on informal discussion, interviews and extensive reviews of the literature, audit regulations and similar questionnaire surveys conducted in prior studies. The reliability of the new scales developed to measure the five factors affecting respondents' perceptions of auditor independence will be presented in Chapter 6.

The scales developed to measure respondents' perceptions enable the study to utilise a multi-item measure of a construct instead of a single item. Diamantopoulos et al. (2012) highlighted the conventional measurement theory that states that items comprising a multi-item measure of a construct represent a random selection from the hypothetical domain of all possible indicators of a construct. Nunnally and Bernstein (1994) supported the reasons

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<sup>20</sup> Content validity refers to the extent to which a specific set of items reflects a content domain (DeVellis 2003).

for using a multi-item scale instead of a single item for measuring psychological attributes. Among others, it was argued that individual items have considerable random measurement error. “The measurement error averages out when individual scores are summed to obtain a total score” (Nunnally and Bernstein 1994, p. 67).

Once the scales for the five factors were established, a composite dependent variable could be developed to reflect an individual’s overall perceptions of each of the five factors affecting auditor independence. The respondents’ overall perceptions of each factor was constructed by adding their scores for the statements related to whether the factor affects respondents’ perceptions, confidence and lending or investing decisions. Since the total statements for each factor were unequal, computing the average scores was more meaningful as the overall perceptions of each factor were better portrayed and comparison between the factors could also be made. The composite scores also created interval variables and thus an interval data scale, which is more informative and powerful than an ordinal scale in that it allows the use of parametric techniques (Cooper and Schindler 2001). Although the distribution of the composite scores was not normal, the use of parametric testing was justified since most of the approaches are indeed ‘robust’ enough as to be able to withstand violations of the parametric assumptions (Pallant 2001; Bryman and Cramer 2005). The following are the parametric tests used in this study:

- 1) **Pearson Product-Moment Correlation test** was conducted to describe the strength and direction of the relationship between two variables.
- 2) **T-test** was used to compare the mean score for two different groups of subjects. This is the parametric alternative to the Mann-Whitney U test which compares means rather than medians of the two groups.
- 3) **ANOVA** is the parametric alternative to the Kruskal-Wallis tests. It was used to determine whether there is a difference in the perceptions of respondents of different ages. The one-way between-group ANOVA was used in this study since there was one independent variable (age) with three or more levels and one dependent variable (i.e. perceptions of NAS).



- 4) **Multivariate ANOVA (MANOVA)** was conducted in order to test if there is a difference between groups (i.e. male/female) on a combination of dependent variables (i.e. perceptions of NAS and financial dependence). MANOVA creates a new summary dependent variable, which is a linear combination of each of the original dependent variables and then performs an ANOVA using this new combined dependent variable<sup>21</sup>.
- 5) **Multiple Regression** allows the current study to examine the impact of all independent variables (i.e. accounting qualifications, age and gender) on a dependent variable (perceptions of auditor independence) in a single model or analysis and determine the relative contribution of each of the variables that make up that model. Dart and Chandler (forthcoming) and Iyer and Raghunandan (2002) are examples of prior studies that used multiple regression to determine whether respondents' background variables affected their perceptions of auditor independence.

Before proceeding with the MANOVA and multiple regression analyses, the study has to ensure that the data conform to the assumptions such as the large sample size, normality, linearity, univariate and multivariate outliers, homogeneity of variance-covariance matrices and multicollinearity. According to Tabachnick and Fidell (2007, p. 251), a sample size of at least twenty in the smallest cell should ensure the “robustness” of the MANOVA. The combined data from the loan officer and professional investor samples were large enough to meet the assumption of the large sample size. In addition, the sizes of the loan officer and professional investor datasets were large enough, permitting a separate analysis on each dataset.

As for the multiple regression, Tabachnick and Fidell (2007) recommended a formula for calculating sample size requirements which takes into account the number of independent

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<sup>21</sup> If a series of ANOVAs were to be conducted separately for each dependent variable, the study runs the risk of an inflated Type I error (finding a significant result when, in reality, there is no significant difference between the groups tested) (Pallant 2001).

variables that the study may wish to use:  $N > 50 + 8m$  (where  $m$  = number of independent variables). With five independent variables, the current study needs at least 90 cases in testing multiple regression. The large sample size created by the combined dataset (loan officers and professional investors) would help the test to be robust to this violation.

The tests performed to check for univariate outliers indicated that there were several outliers in all the datasets but no extreme outliers were detected in the loan officer, professional investor and overall datasets. In checking multivariate normality and outliers, Mahalanobis distances were calculated (by SPSS, using regression) for each dataset. Analysis of Mahalanobis distances should help pick up on any cases displaying a strange pattern of scores across the five dependent variables. The Mahalanobis distance value was compared against a critical value (using a chi-square critical value table). An individual value that exceeds the critical value is considered an outlier. As a result, two extreme outliers were found and were deleted from the loan officer and overall datasets.

Apart from normality and outliers issues, the study also ensured that the dependent variables were not subject to multicollinearity. The Pearson correlation tests for all datasets indicated no reason for concern as the correlations between the dependent variables ranged from small to medium. In addition, SPSS also performed 'collinearity diagnostics' on the variables and presented Tolerance and Variance Inflation Factors which also confirmed that there was no evidence of multicollinearity as none of the values were very low (near zero).

Finally, the assumptions of homoscedasticity and independence of residuals also need to be met in order to run multiple regression analysis. These assumptions can be checked by examining the residuals scatterplot and the normal probability plot of the regression standardised residuals that were requested as part of the analysis.

## **5.14 Chapter Summary**

This chapter discusses the methodology utilised in this study. The chapter starts with a brief discussion on the research paradigms and choice of research methods available for the study to adopt. This study employs a positivist position and used a postal questionnaire method as the method of data collection. The justifications for the choice of this research paradigm and research method are provided and their limitations acknowledged. Steps taken to minimise these limitations are also highlighted.

This chapter further describes in detail the process and procedures involved in undertaking the survey. Discussions on the process of obtaining ethical approval for the study and the questionnaire pilot tests are also presented. The rationale for the sample selection is explained and analysis of survey responses is presented. Analysis indicated that 38% of respondents responded to the survey. Therefore, a test for non-response bias was performed and the results showed that the non-response bias was minimal.

The issue of questionnaire data reliability is also highlighted in this chapter. It was found that reliability of the questionnaire data was not an issue as the Cronbach alpha coefficients indicated values exceeding the minimum required value (0.7). Finally, the types of statistical technique, parametric and non-parametric testing, used to analyse the survey results are also discussed. Since the normality tests showed that the distribution of responses was non-normal, the main statistical technique that was used to analyse the data was non-parametric testing. Parametric techniques were also used after the questionnaire responses were converted into composite scores where respondents' responses to the statements within each theme were combined.

The following chapter will discuss the findings of the research.

## **CHAPTER 6 – RESULTS OF QUESTIONNAIRE SURVEY**

### **6.1 Introduction**

This thesis investigates the perceptions of Malaysian financial statement users relating to the impact of several factors on auditor independence. In Chapter 5, the use of the postal questionnaire survey was justified and the sample selection was discussed in detail.

The aim of this chapter is to analyse the responses to the postal questionnaire survey. This chapter begins with Section 6.2 which describes details of respondents' background. Section 6.3 presents findings on the impact of long audit tenure on auditor independence and this is followed by Section 6.4 that discusses findings on the issue of auditors' fee dependence on a single audit client. Section 6.5 highlights issues related to the provision of NAS. Section 6.6 examines the impact of auditors' employment with audit clients on perceptions of auditor independence and Section 6.7 discusses audit committee issues. Section 6.8 considers the effect of other safeguards on auditor independence. Section 6.9 examines the respondents' perceptions of the importance of an audit report. Section 6.10 explores the relationships between the findings and the variables of the respondents' background such as accounting knowledge, prior experience as accountants or auditors, age and gender. Section 6.10 also compares the two groups of respondents' perceptions of auditor independence. Section 6.11 discusses the development of composite scores and the use of Cronbach Alpha coefficient to measure the reliability of a scale. In Section 6.12 through to Section 6.15, analyses of responses using parametric tests are presented. Finally, Section 6.16 provides a conclusion to this chapter.

### **6.2 Respondents' Background**

Before the results of the questionnaire survey are reported, it is important that the background information of respondents in this study is presented. The respondents were asked about their gender, age, position, experience, academic qualification, field of study and prior working experience as accountants in industry or as auditors in audit firms. This

information is important since it provides an overall impression of the population of loan officers and professional investors in Malaysia who have been selected as respondents in this study, allowing for investigation of some of the factors that may influence the findings.

As reported in the previous chapter, 110 and 67 usable responses were received after three mailings from loan officers and professional investors respectively. An analysis was carried out of the designation of the respondents and the findings are tabulated in Table 6.1. The majority of the loan officers responding to the questionnaire were in managerial positions where 34% were managers and 19% were assistant managers. Another 20% were senior loan officers, 29% were officers and the remainder (1%) did not state his or her designation. Since the majority of the loan officers were in managerial positions, they were most likely to be involved in the loan approval process for the banking group. The seniority of the respondents may provide a strong support for the belief that their responses would give a more reliable and authoritative source of information on the issue under study.

As for the professional investors, the majority of the respondents were analysts (58%) with investment analysts representing 31% of the sample. Another 39% were fund managers and the remaining 3% (2 individuals) consisted of a dealer representative and a stock broking company director.

<b>Table 6.1: Respondents' Designation</b>					
<b>Loan Officers</b>			<b>Professional Investors</b>		
	Frequency	%		Frequency	%
Manager	37	33.6	Financial Analyst	7	10.4
Assistant Manager	21	19.1	Investment Analyst	21	31.3
Senior Officer	22	20.0	Other Analyst	11	16.4
Officer	29	26.4	Fund Manager	26	38.8
Not Stated	1	0.9	Others:		
			Dealer representative	1	1.5
			Director	1	1.5
<b>Total</b>	<b>110</b>	<b>100.0</b>	<b>Total</b>	<b>67</b>	<b>100.0</b>

Table 6.2 shows the distribution of the respondents' length of experience as loan officers and professional investors. It is observed that more than 60% of the respondents in both groups had more than five years' experience in their respective functions. The length of work experience as loan officers or professional investors may indicate that the respondents are well versed in their job functions and that their responses are likely to be more reliable and authoritative than those with less experience.

<b>Table 6.2: Respondents' Length of Work Experience</b>				
	<b>Loan Officers</b>		<b>Professional Investors</b>	
	Frequency	%	Frequency	%
<b>Experience:</b>				
Less than 5 years	42	38.2	21	31.3
5 – 10 years	32	29.1	23	34.3
11 – 15 years	20	18.2	18	26.9
16 – 20 years	12	10.9	4	6.0
More than 20 years	4	3.6	1	1.5
<b>Total</b>	<b>110</b>	<b>100.0</b>	<b>67</b>	<b>100.0</b>

Table 6.3 exhibits the distribution of loan officers' and professional investors' genders and ages. It shows that the majority of the respondents were male. Table 6.3 also reveals that the majority of the respondents were at least 31 years old. The information on gender and age is important in this study since it is expected that these factors may influence respondents' perceptions of auditor independence. This will be tested later against the respondents' answers.

<b>Table 6.3: Respondents' Gender and Age</b>				
	<b>Loan Officers</b>		<b>Professional Investors</b>	
	Frequency	%	Frequency	%
<b>Gender:</b>				
Male	58	52.7	41	61.2
Female	52	47.3	26	38.8
<b>Total</b>	<b>110</b>	<b>100.0</b>	<b>67</b>	<b>100.0</b>
<b>Age:</b>				
30 years or less	39	35.5	28	41.8
31 – 40 years	44	40.0	19	28.4
41 – 50 years	24	21.8	15	22.4
51 – 60 years	3	2.7	5	7.5
Above 60 years	0	0	0	0
<b>Total</b>	<b>110</b>	<b>100.0</b>	<b>67</b>	<b>100.0</b>

Table 6.4 tabulates the distribution of the respondents' highest academic qualification, field of study, professional qualifications and prior experience as accountants in industry or auditors in an audit firm. It can be seen that the majority of loan officers (76%) and professional investors (63%) held a Bachelors degree and this was followed by a Masters degree (15% and 24%). Five loan officers (5%) and seven professional investors (10%) stated that their highest qualification was a professional qualification. Sixteen other loan officers and sixteen other professional investors held both a degree and a professional qualification. This gives a total of 21 loan officers and 23 professional investors with professional qualifications. Most of the loan officers with a professional qualification held a Certified Credit Professional (CCP) qualification while a number of professional investors held a Certified Financial Planner (CFP) and Certified Financial Analyst (CFA) qualifications. Very few of the respondents indicated that they had an accounting qualification such as the ACCA which is perhaps unsurprising since CCP qualifications for the loan officers and CFP and CFA qualifications for the professional investors are more relevant to their work requirements.

Table 6.4 also indicates that 40% of the loan officers had an accounting background. The rest had a background in Finance, Business, Economics or other areas such as sciences, mathematics and engineering. As for the professional investors, 48% stated that they had a finance background and others claimed to have a background in accounting, business, economics and sciences.

<b>Table 6.4: Respondents' Academic Qualifications, Field of Study, Professional Qualifications and Work Experience as Accountants or Auditors</b>				
	<b>Loan Officers</b>		<b>Professional Investors</b>	
	Frequency	%	Frequency	%
<b>Academic Qualification:</b>				
Diploma	4	3.6	1	1.5
Bachelor Degree	83	75.5	42	62.7
Masters' Degree	16	14.5	16	23.9
Phd	1	0.9	1	1.5
Professional	5	4.5	7	10.4
Not stated	1	0.9	0	0
<b>Total</b>	<b>110</b>	<b>100.0</b>	<b>67</b>	<b>100.0</b>
<b>Field of Study:</b>				
Finance	30	27.2	32	47.8
Accounting	44	40.0	20	29.9
Business	20	18.2	11	16.4
Economics	8	7.3	3	4.5
Others (Sciences / /Mathematics /Engineering)	8	7.3	1	1.5
<b>Total</b>	<b>110</b>	<b>100.0</b>	<b>67</b>	<b>100.0</b>
<b>Professional Qualification:</b>				
Yes	21	19.1	23	34.3
No	89	80.9	44	65.7
<b>Total</b>	<b>110</b>	<b>100.0</b>	<b>67</b>	<b>100.0</b>
<b>Work Experience as:</b>				
Accountant in Industry	3	2.7	6	9.0
Auditor in a Big Four firm	12	10.9	8	11.9
Auditor in a medium accounting firm	7	6.4	2	3.0
Auditor in a small accounting firm	2	1.8	-	-
None	86	78.2	51	76.1
<b>Total</b>	<b>110</b>	<b>100.0</b>	<b>67</b>	<b>100.0</b>



Finally, the respondents were also asked whether they had prior work experience as an accountant in industry or auditor in an audit firm. The results in Table 6.4 reveal that almost 22% of the loan officers and 24% of the professional investors had some prior experience as accountants in industry or auditors in audit firms. Their experience ranged from one year to six years in the said positions. This question is important, along with the question related to whether the respondents have any accounting background since it might be expected to influence their perceptions of auditor independence and as a result, will be tested.

The next section will present results of the survey questionnaire by the loan officers and professional investors relating to the issue of long audit tenure. As discussed in the previous chapter, this study uses a five-point Likert scale (ranging from ‘strongly disagree’ to ‘strongly agree’) to indicate respondents’ agreement with the statements in the questionnaire survey. For presentational purposes, the ‘strongly disagree’ and ‘disagree’ points have been grouped into ‘disagree’, and the ‘strongly agree’ and ‘agree’ have been grouped into ‘agree’.

### **6.3 Respondents’ Perceptions of Long Audit Tenure**

This section will establish whether loan officers and professional investors in Malaysia perceive long audit tenure as a threat to auditor independence. At this point, it is worthwhile to reiterate the first hypothesis of the study that relates to this issue:

*H<sub>1a</sub>: The length of auditor tenure will not affect loan officers’ and professional investors’ perceptions of auditor independence.*

Table 6.5 reveals that the majority of loan officers (58%) and professional investors (66%) perceived a lengthy relationship between an auditor and a client company as a threat to auditor independence. The table also indicates that the respondents’ confidence in an auditor’s independence was affected if there is a lengthy association between an auditor and a client company. However, when asked whether they consider the length of auditor-

client relationships when deciding whether to lend to or invest in a company, 47% of the loan officers and 43% of the professional investors were neutral. These findings may indicate that even though the information was not considered in making lending and investing decisions, the respondents are aware of the potential threat of long audit tenure. They may be worried that long audit tenure may cause auditors to become cosy in their relationships with audit clients which may lead to complacency in doing their audit work. Similar arguments were made by Mautz and Sharaf (1961) and Shockley (1982).

To support the descriptive findings, the one-sample Wilcoxon signed ranks test (WSRT) was conducted. This test is a non-parametric alternative to the one-sample t-test to measure the tendency of respondents to perceive that long audit tenure negatively affects auditor independence (i.e. medians are higher than 3). The results in Table 6.5 show that the medians differ significantly from 3 for both groups of respondents. These results suggest that the loan officers and professional investors in this study tended to perceive a lengthy relationship as a threat to independence and it affects their confidence in an auditor's ability to remain independent. Based on these results, Hypothesis 1a can be rejected and it can be concluded that long auditor-client relationships *do* have an impact on the respondents' perceptions of auditor independence.

<b>Table 6.5: Respondents' Perceptions of Long Audit Tenure</b>								
	<b>Loan Officers (n = 110)</b>			<b>Professional Investors (n = 67)</b>			<b>One-Sample WSRT (test value = 3)</b>	
	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Loan Officers (Sig)</b>	<b>Prof. Investors (Sig)</b>
A lengthy relationship between an auditor and a client company is a threat to auditor independence.	15.5%	26.4%	58.1%	16.4%	17.9%	65.7%	0.000*	0.000*
A lengthy relationship with an audit client affects my confidence in an auditor's independence.	27.3%	21.8%	50.9%	16.4%	23.9%	59.7%	0.010*	0.000*
In making lending/investment decisions, I take into consideration the length of the relationship between the company and its auditor.	27.3%	47.2%	25.5%	38.8%	43.3%	17.9%	0.964	0.061

\*Significant at the 5% level.

### 6.3.1 Respondents' Perceptions of Audit Partner Rotation and Audit Firm Rotation

In this study, perceptions of the implementation of two types of auditor rotation were examined, namely: audit firm rotation and audit partner rotation. The hypotheses tested are as follows:

*H<sub>1b</sub>: Audit partner rotation will not affect loan officers' and professional investors' perceptions of auditor independence.*

*H<sub>1c</sub>: Loan officers and professional investors perceive that the audit partner rotation policy should not be replaced with an audit firm rotation policy.*

Table 6.6 reveals that a clear majority of loan officers (73%) and professional investors (78%) agreed that the current audit partner rotation policy would enhance auditor independence. However, when asked whether 'the policy of audit partner rotation should be replaced with a policy of audit firm rotation', 42% of the loan officers concurred with the statement whereas only 24% of the professional investors showed a positive response. These results seem to suggest that for the loan officers, the current regulation may not be sufficient and a more stringent measure should be implemented to further safeguard auditor independence. The loan officers' agreement with the implementation of audit firm rotation may be due to their perceptions that the likely benefits of audit firm rotation exceed the likely benefits of audit partner rotation, for just above 40% of them agreed with that statement. On the other hand, only one-quarter of the professional investors in this study agreed that the likely benefits of mandatory audit firm rotation would exceed the benefits from the current regulation while the majority of them (51%) remained neutral.

Despite the differences in the loan officers' and professional investors' perceptions of mandatory audit firm rotation, Table 6.6 also shows a consensus between the two groups of respondents as the majority of them agreed that the implementation of audit firm rotation would add more costs to audit firms and their audit clients. These results support the claim by Arrunada and Paz Ares (1997) that mandatory audit firm rotation makes an audit more costly due to increments in production costs. Fearnley and Beattie (2002) also stated that

regular rotation of audit firms and companies will not only add costs to both parties but also management time for the companies and learning time for the auditors.

The results of the one-sample WSRT in Table 6.6 are statistically significant, indicating that the respondents tended to perceive that the current rotation policy will positively affect independence perceptions. Based on these results, Hypothesis 1b can be rejected and it can be concluded that the audit partner rotation *does* affect the respondents' perceptions of auditor independence.

As for Hypothesis 1c, the result of the one-sample WSRT is statistically significant which suggests that the loan officers tended to agree that the current audit partner rotation policy should be replaced with mandatory audit firm rotation. However, the result of the WSRT is not significant for the professional investors; it indicates their tendency to be neutral concerning the implementation of an audit firm rotation policy. Based on these results, Hypothesis 1c is only rejected for the loan officer sample since the evidence support audit partner rotation policy to be replaced with an audit firm rotation policy.

<b>Table 6.6: Respondents' Perceptions of Audit Partner Rotation and Audit Firm Rotation</b>								
	<b>Loan Officers (n = 110)</b>			<b>Professional Investors (n = 67)</b>			<b>One-Sample WSRT (test value = 3)</b>	
	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Loan Officers (Sig)</b>	<b>Prof. Investors (Sig)</b>
The implementation of audit <u>partner</u> rotation will enhance auditor independence.	6.4%	20.9%	72.7%	3.0%	19.4%	77.6%	0.000*	0.000*
The policy of audit <u>partner</u> rotation should be replaced with a policy of audit <u>firm</u> rotation.	18.2%	40.0%	41.8%	29.9%	46.2%	23.9%	0.001*	0.676
The likely benefits of audit <u>firm</u> rotation exceed the likely benefits of audit <u>partner</u> rotation.	19.1%	40.0%	40.9%	23.9%	50.7%	25.4%	0.001*	0.220
The implementation of audit <u>firm</u> rotation would add more costs to audit firms and audit clients.	10.0%	36.4%	53.6%	4.5%	37.3%	58.2%	0.000*	0.000*

\* Significant at the 5% level.

Table 6.7 shows respondents' perceptions of how often audit firms should rotate their audit partners and in the case of mandatory audit firm rotation, how often audit firms should rotate.

Based on the MIA By-Laws, audit firms should rotate their audit partners every five years while the IFAC (2009) requires audit partners to be rotated every seven years. Table 6.7 reveals that 45% of loan officers and just over half (51%) of professional investors indicated that audit firms should rotate their audit partners every 5-7 years. Nonetheless, there is also some evidence to support the belief that the rotation period should be at least every 3-4 years. These results show that there were some concerns among the respondents that the current rotation period is insufficient to safeguard the auditor from the problems relating to lengthy tenure.

If a mandatory audit firm rotation is to be implemented, the result shows that there is only a slight change in the loan officers' perceptions. However, the professional investors' perceptions change dramatically. Only 25% of the professional investors indicated their preference that audit firms should be rotated every 5-7 years. 24% of the respondents in the group did not support the policy of mandatory audit firm rotation at all. This finding further supports the earlier result that professional investors seem satisfied with the current regulation and that some of them might disagree with the implementation of mandatory audit firm rotation.

<b>Table 6.7: Respondents' Perceptions of How Often Audit Partners and Audit Firms Should Rotate</b>				
	<b>Audit Partner Rotation</b>		<b>Audit Firm Rotation</b>	
	<b>Loan Officers (n = 110)</b>	<b>Professional Investors (n = 67)</b>	<b>Loan Officers (n = 110)</b>	<b>Professional Investors (n = 67)</b>
1-2 years	12%	6%	2%	8%
3-4 years	27%	34%	26%	22%
5-7 years	45%	51%	46%	25%
8-10 years	15%	7%	16%	19%
10-20 years	0	0	3%	2%
> 20 years	1%	0	1%	0
Never	0	2%	6%	24%

The following section will analyse responses to the questionnaire survey relating to auditors' economic dependence on a single audit client.

#### **6.4 Respondents' Perceptions of Economic Dependence**

Table 6.8 shows the results of loan officers' and professional investors' perceptions of auditors' economic dependence on a single audit client. The research hypotheses relating to the issue of auditors' financial dependence are as follows:

*H<sub>2a</sub>: Loan officers' and professional investors' perceptions of auditor independence will not be affected by the dependence of the audit firm on income from a single audit client.*

*H<sub>2b</sub>: Loan officers' and professional investors' perceptions of auditor independence will not be affected by the dependence of an individual audit partner on income from a single audit client.*

The results in Table 6.8 show that a large majority of loan officers (80%) and professional investors (88%) agreed that income from audit fees from a single audit client could cause an audit firm to become economically dependent upon that client. Because of this economic dependency, more than half (51%) of the loan officers and (55%) professional investors did not believe that audit firms could maintain their independence from that client. Moreover, the majority of the loan officers (70%) and professional investors (73%) perceived that the independence of audit partners would be affected if their total income were generated from a single audit client.

Table 6.8 further reveals that 46% of the loan officers and almost half (49%) of the professional investors did not consider the amount of audit fees a company paid to its auditor when making lending or investment decisions. However, the respondents' concern about the threat faced by auditors is reflected in their responses as the majority of the loan officers (51%) and professional investors (60%) believed that their decisions to lend to or invest in a company would be affected if they perceived the auditors to be economically

dependent upon the client company. This finding indicates that the knowledge that auditors are financially dependent on a single client is crucial as it would affect the respondents' lending and investing decisions.

Responses as to whether the two groups of respondents believed that audit firms could maintain their independence from a client when financially dependent upon that client are used to test Hypothesis 2a. The results of the one-sample WSRT reveal statistically significant differences between the samples' medians and 3, thus confirming the earlier descriptive results and suggesting the tendency of the two respondent groups to disagree with the statement. Based on these findings, Hypothesis 2a is rejected and it can be concluded that the respondents' perceptions of auditor independence *are* affected by the dependence of an audit firm on income from a single audit client.

As for Hypothesis 2b, the results of the one-sample WSRT are significant which indicate that the respondents tended to believe that the independence of audit partners will be affected if they are dependent on a single audit client. Based on these results, Hypothesis 2b is rejected.

**Table 6.8: Respondents' Perceptions of Auditors' Economic Dependence on a Single Audit Client**

	Loan Officers (n = 110)			Professional Investors (n = 67)			One-Sample WSRT (test value = 3)	
	Disagree	Neutral	Agree	Disagree	Neutral	Agree	Loan Officers (Sig)	Prof. Investors (Sig)
Income from audit fees received from a single audit client could cause an audit firm to become economically dependent upon that client.	3.6%	16.4%	80.0%	4.5%	7.4%	88.1%	0.000*	0.000*
Even though an audit firm is economically dependent upon its audit client, it could still maintain its independence from that client.	50.9%	28.2%	20.9%	55.2%	25.4%	19.4%	0.001*	0.000*
When an audit partner's income is dependent on total fees generated from a single audit client, his/her ability to remain independent would be affected.	4.5%	25.5%	70.0%	4.5%	22.4%	73.1%	0.000*	0.000*
In making lending/investment decisions, I take into consideration the amount of audit fees the company pays to its auditor.	46.3%	27.3%	26.4%	49.3%	31.3%	19.4%	0.009*	0.004*
My lending/investment decisions for a company would be affected if I perceive its auditors to be economically dependent upon it.	15.5%	33.6%	50.9%	6.0%	34.3%	59.7%	0.000*	0.000*

\* Significant at the 5% level.



#### **6.4.1 Respondents' Perceptions of 15% Limit on Audit Firms Total Income from a Single Audit Client**

Table 6.9 reports respondents' perceptions of whether the 15% limit on audit firms' total income from any one client (as imposed by the MIA By-Laws) is sufficient to safeguard auditor independence from the threat of financial dependence. The hypothesis tested is as follows:

*H<sub>2c</sub>: A 15% limit on audit firms' total income that the firms may receive from any one client is not sufficient to safeguard auditor independence from problems that may arise due to fee dependence.*

Based on Table 6.9, it is revealed that the majority of loan officers (56%) and professional investors (52%) perceived that the current 15% limit on income that audit firms may receive from a single audit client is sufficient to safeguard auditor independence. The results of the one-sample WSRT are statistically significant; they indicate the tendency of the respondents to agree with the sufficiency of the current limit. Table 6.9 also reveals that, of the respondents who perceived the 15% limit to be inadequate, the majority of them believed that the income limit should be less than 15%. These results seem to suggest that some of the respondents are very concerned about the threat of financial dependence and that their decisions would be affected if they were to perceive the auditors to be heavily dependent on a single client company.

Based on the results presented, Hypothesis 2c is rejected and it can be concluded that the majority of respondents believed that the 15% limit on income from a single audit client *is* sufficient to safeguard independence from problems that may arise due to fee dependence.

<b>Table 6.9: Respondents' Perceptions of the Sufficiency of 15% Limit on Audit Firms' Total Income</b>								
	<b>Loan Officers (n = 110)</b>			<b>Professional Investors (n = 67)</b>			<b>One-Sample WSRT (test value = 3)</b>	
	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Loan Officers (Sig)</b>	<b>Prof. Investors (Sig)</b>
15% limit on audit firms' total income is sufficient to safeguard independence.	10%	33.6%	56.4%	26.9%	20.9%	52.2%	0.000*	0.033*
* Significant at the 5% level.								
<b>Of those who perceive that 15% limit is not adequate:</b>	<b>Loan Officers (n=11)</b>			<b>Professional Investors (n=18)</b>				
It should be < than 15%	55%			89%			N/A	
It should be 16% - 20%	9%			0			N/A	
It should be > than 21%	36%			11%			N/A	

In the next section, results of the questionnaire survey that relate to provisions of NAS by auditors to their audit clients will be presented.

## 6.5 Respondents' Perceptions of NAS

Table 6.10 reports respondents' perceptions of NAS provision by auditors to their audit clients. The responses will be used to test the following research hypothesis that relates to NAS:

*H<sub>3a</sub>: The provision of NAS by audit firms to audit clients will not affect loan officers' and professional investors' perceptions of auditor independence.*

Table 6.10 reveals that when auditors provide NAS to an audit client, only 37% of the loan officers and 28% of the professional investors agreed that the auditors might perform an efficient and effective audit. Similarly, only 37% of the loan officers and a much lower percentage (13%) of the professional investors perceived that auditors might have an increased ability to resist management pressure when they provide NAS for an audit client. In contrast, 48% of the loan officers and 45% of the professional investors believed that auditors might tend to make difficult audit decisions in favour of their clients. Just above

48% of the loan officers and the majority of the professional investors (52%) agreed with the statement that auditors may sacrifice their objectivity in order to retain high non-audit fee-paying clients. These findings contradict Simunic's (1984) and Goldman and Barlev's (1974) suggestions that NAS could enhance the auditor's knowledge of their clients, resulting in a more efficient and effective audit and increasing their relative power over the clients. Conversely, the findings seem to suggest that the respondents are more concerned about the negative impacts when auditors provide NAS to audit clients.

Table 6.10 also shows that 46% of the loan officers and the majority of the professional investors (58%) perceived that their confidence in an auditor's independence would be affected if the auditor provides NAS to an audit client. This finding indicates that the respondents are worried about the consequences when auditors provide NAS to their audit clients. However, in making decisions whether or not to lend to or invest in a company, the majority of the respondents in both groups did not consider the amount of non-audit fees the company pays to its auditor.

To test Hypothesis 3a, responses to the statement 'When an auditor provides non-audit services to an existing audit client, my confidence in the auditor's ability to remain independent would be affected' are used. 46% of the loan officers and the majority of professional investors agreed with the statement. The results of the one-sample WSRT are statistically significant which also suggest the tendency of the respondents to agree with the statement. Based on these findings, Hypothesis 3a is rejected and it can be concluded that the provisions of NAS by audit firms to their audit clients have an impact on respondents' perceptions of auditor independence.

<b>Table 6.10: Respondents' Perceptions of NAS Provision by Auditors to Their Audit Clients</b>								
	<b>Loan Officers (n = 110)</b>			<b>Professional Investors (n = 67)</b>			<b>One-Sample WSRT (test value = 3)</b>	
	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Loan Officers (Sig)</b>	<b>Prof. Investors (Sig)</b>
When an auditor provides non-audit services to an existing audit client, the auditor may:								
• perform a more efficient and effective audit.	20.9%	41.8%	37.3%	20.9%	50.7%	28.4%	0.018*	0.260
• have an increased ability to resist client pressure	19.1%	43.6%	37.3%	28.4%	58.2%	13.4%	0.011*	0.059
• tend to make difficult audit decisions in favour of the client.	12.7%	39.1%	48.2%	9%	46.2%	44.8%	0.000*	0.000*
• sacrifice his/her objectivity in order to retain that high non-audit fee-paying client.	12.7%	39.1%	48.2%	7.5%	40.3%	52.2%	0.000*	0.000*
When an auditor provides non-audit services to an existing audit client, my confidence in the auditor's ability to remain independent would be affected.	16.3%	38.2%	45.5%	9.0%	32.8%	58.2%	0.000*	0.000*
In making lending/investment decisions, I take into consideration the amount of non-audit fees the company pays to its auditor.	30.0%	41.8%	28.2%	25.3%	49.3%	25.4%	0.799	0.745

\*Significant at the 5% level.

### 6.5.1 Respondents' Perceptions of Methods of NAS Provisions

As mentioned in Chapter 2, it was suggested that, the separation of staff for audit and NAS or to spin off NAS into different divisions within the audit firms, could mitigate concerns that NAS provided to audit clients may impair auditor independence (Mautz and Sharaf 1961; Hillison and Kennelley 1988). The hypothesis that is related to this issue is as follows:

*H<sub>3b</sub>: There is no significant difference in loan officers' and professional investors' perceptions of auditor independence when NAS are performed by the same audit personnel and when the staff for audit and NAS are separated.*

Descriptive analysis in Table 6.11 shows that an overwhelming majority of loan officers (77%) and professional investors (79%) were against the provision of NAS by audit personnel as they perceived that it would threaten auditor independence. However, if different personnel from a separate department within the same audit firm and if a different firm (one in which the auditors have an interest) were to provide NAS, the perceptions that auditor independence would be threatened reduced significantly. In addition, when full disclosures are made in the clients' financial statements and the same personnel are involved in the audit, 41% of the loan officers believed that auditor independence would be threatened while the majority of professional investors (52%) were neutral. The results in Table 6.11 also reveal a higher percentage of agreement that auditor independence would be threatened when a different firm (one in which the auditors have an interest) were to provide NAS than when staff from a separate department within the same audit firm were to provide NAS. Interestingly, these findings suggest that respondents place more confidence in auditor independence when audit and NAS are performed by different staff within the same audit firm than if the services were performed by different firms.

The one-sample WSRT were also performed and the results, as tabulated in Table 6.11, are statistically significant when the same audit personnel provide NAS and when the same audit personnel provide NAS but full disclosures are made in the client's financial statements, which confirm the earlier concerns that the joint provision of NAS would threaten auditor independence. The results, however, are not significant when personnel from a separate department within the same audit firm provide NAS to audit clients. Similar results are also found when a separate firm in which auditors have an interest provides NAS but only for the professional investor group. The WSRT result for the loan officers is statistically significant which indicates the tendency of the group to negatively perceive a separate firm where auditors have an interest in providing NAS to audit clients.

Table 6.11 further reports that just over 47% of the loan officers and professional investors did not support the suggestion to ban audit firms from providing NAS. Instead they are in favour of NAS provisions to non-audit clients only. Moreover, it is disclosed that the

majority of loan officers and professional investors agreed that an audit committee's approval should be obtained before a company auditor could provide any NAS. This result highlights the importance of the role of an audit committee regarding the issue of NAS.

**Table 6.11: Respondents' Perceptions of Methods of NAS Provision**

	Loan Officers (n = 110)			Professional Investors (n = 67)			One-Sample WSRT (test value = 3)	
	Disagree	Neutral	Agree	Disagree	Neutral	Agree	Loan Officers (Sig)	Prof. Investors (Sig)
In my opinion, auditor independence would be threatened if NAS are provided by: • the same personnel involved in the audit.	7.3%	15.5%	77.2%	6.0%	14.9%	79.1%	0.000*	0.000*
• personnel from a separate department within the audit firm.	22.7%	43.7%	33.6%	19.4%	55.2%	25.4%	0.172	0.465
• a separate firm where the auditors have an interest.	18.2%	32.7%	49.1%	25.4%	41.8%	32.8%	0.001*	0.355
• the same personnel involved in the audit but full disclosures are made in the client's financial statements.	19.1%	40%	40.9%	9.0%	52.2%	38.8%	0.002*	0.000*
Audit firms should be totally banned from providing non-audit services.	47.3%	29.1%	23.6%	47.8%	31.3%	20.9%	0.007*	0.033*
Audit firms should provide non-audit services to non-audit clients only.	24.5%	31.9%	43.6%	7.5%	32.8%	59.7%	0.010*	0.000*
The audit committee's approval should be sought before any non-audit services could be provided by an existing company auditor.	6.4%	20.9%	72.7%	3.0%	29.8%	67.2%	0.000*	0.000*

\* Significant at the 5% level.

In order to determine whether there is any statistically significant difference in the respondents' perceptions of the four methods of provision of NAS, the non-parametric Friedman test was used. As tabulated in Table 6.12, the results of the Friedman test indicate statistically significant differences in the responses for the four types of NAS provisions for the loan officer and professional investor samples. Based on the mean ranks, it also appears

that the respondents believed the provision of NAS by audit personnel as the greatest threat to auditor independence. The provision of NAS by the same audit personnel but with full disclosures was ranked second in the professional sample which may indicate that in general they are still concerned about the threat to auditor independence even when full disclosures are made in the client's financial statement. The results also show that the provision of NAS by personnel from a separate department within the audit firm was perceived as the lesser threat to auditor independence compared to when a separate firm where the auditors have an interest performs NAS.

<b>Table 6.12: Analysis of Differences in Respondents' Perceptions of Methods of NAS Provisions using the Friedman Test</b>		
	<b>Mean Rank<sup>a</sup> (Ranking)</b>	
	<b>Loan Officers (n = 110)</b>	<b>Professional Investors (n = 67)</b>
Auditor independence would be threatened if NAS are provided by:		
(a) the same audit personnel involved in audit	3.15 (1)	3.40 (1)
(b) personnel from a separate department within the audit firm	2.12 (4)	2.05 (4)
(c) a separate firm where the auditors have an interest	2.42 (2)	2.17 (3)
(d) the same personnel involved in audit but full disclosures are made in the client's financial statements	2.31 (3)	2.38 (2)
	Chi-square = 67.491 df = 3 p = 0.000*	Chi-square = 74.970 df = 3 p = 0.000*

<sup>a</sup> The higher the mean rank, the more the respondents agreed with the above statements.

\* Significant at the 5% level.

The Wilcoxon matched-pairs signed rank test was performed to determine if there is any significant difference in the responses when two methods of NAS provisions were compared. The results of the test, as shown in Table 6.13, reveal that there are statistically significant differences between the provision of NAS by audit personnel and other methods of NAS provision to audit clients which confirm the findings from the Friedman test. The

results also support the earlier suggestion that the threat to auditor independence would reduce significantly when NAS are provided by personnel from a separate department or from different firms where the auditors have an interest.

Based on the results presented, Hypothesis 3b is rejected as it appears that there are significant differences in the loan officers' and professional investors' perceptions of auditor independence when NAS are performed by the same audit personnel and when the staff for audit and NAS are separated.

<b>Table 6.13: Analysis of Differences in Respondents' Perceptions of Methods of NAS Provisions using the Wilcoxon Matched-Pairs Signed Rank Test</b>		
<b>Pairs</b>	<b>Loan Officers</b>	<b>Professional Investors</b>
(b)&(a)	$z = -6.043, p = 0.000^*$	$z = -5.101, p = 0.000^*$
(c)&(a)	$z = -4.897, p = 0.000^*$	$z = -4.950, p = 0.000^*$
(d)&(a)	$z = -5.464, p = 0.000^*$	$z = -5.109, p = 0.000^*$
(b)&(c)	$z = -2.381, p = 0.017^*$	$z = -1.436, p = 0.151$
(b)&(d)	$z = -2.147, p = 0.032^*$	$z = -2.462, p = 0.014^*$
(c)&(d)	$z = -0.235, p = 0.814$	$z = -3.150, p = 0.002^*$
<p>* Significant at the 5% level.</p> <p>Auditor independence would be threatened if NAS are provided by:</p> <p>(a) the same audit personnel involved in audit,</p> <p>(b) personnel from a separate department within the audit firm,</p> <p>(c) a separate firm where the auditors have an interest,</p> <p>(d) the same personnel involved in audit but full disclosures are made in the in the client's financial statements.</p>		

## 6.5.2 Respondents' Perceptions of the Need to Prescribe a Maximum Percentage of NAS Fees to Total Fees

Table 6.14 shows respondents' perceptions of the need to prescribe a maximum percentage of NAS fees to total fees by accounting regulators in order to safeguard auditors from relying too much on income from NAS. The hypothesis tested is as follows:



*H<sub>3c</sub>: The maximum percentage of non-audit fees to total fees paid by a particular audit client should not be prescribed by the accounting regulators.*

Table 6.14 reveals that a large majority of loan officers (73%) and professional investors (60%) wanted a maximum percentage of NAS fees to total fees from an audit client to be prescribed by the accounting regulators to safeguard auditor independence. The results of the WSRT are also statistically significant, indicating the tendency of the respondents to agree with the statement. Of those respondents who perceived that a maximum percentage should be prescribed, 38% and 45% of the loan officers and professional investors respectively preferred the limit of NAS fees income from an audit client to be within 15%-20% of the total income received from that client. A further 33% of the loan officers and 40% of the professional investors wanted the limit to be less than 15%. This could mean that some respondents are more critical in their perception that auditors' ability to remain independent would be affected if their NAS income percentage from an audit client were to exceed the 15% limit. This finding provides the evidence that there is a need for the regulators to prescribe a maximum percentage of NAS fees to total fees as this is perceived by the respondents as a safeguard to independence.

<b>Table 6.14: Respondents' Perceptions of the Need to Prescribe a Maximum Percentage of NAS Fees to Total Fees</b>								
	<b>Loan Officers (n = 110)</b>			<b>Professional Investors (n = 67)</b>			<b>One-Sample WSRT (test value = 3)</b>	
	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Loan Officers (Sig)</b>	<b>Prof. Investors (Sig)</b>
A maximum percentage of NAS fees to total fees should be prescribed as a safeguard to auditor independence.	7.3%	20%	72.7%	3.0%	37.3%	59.7%	0.000*	0.000*
* Significant at the 5% level								
<b>Of those who perceive that a maximum percentage of NAS fees to total fees should be prescribed:</b>	<b>Loan Officers (n=82)</b>			<b>Professional Investors (n=40)</b>				
It should be < than 15%	33%			40%			N/A	
It should be 16% - 20%	38%			45%			N/A	
It should be 21% - 50%	21%			15%			N/A	
It should be > than 51%	8%			0%			N/A	

Based on the results presented, Hypothesis 3c is rejected and it can be concluded that the respondents believed that a maximum percentage of NAS fees to total fees from an audit client should be prescribed by the accounting regulators to safeguard auditor independence.

### **6.5.3 Respondents' Perceptions of Different Types of NAS**

Table 6.15 shows respondents' perceptions as to whether the different types of NAS would impair auditor independence. The hypothesis tested is as follows:

*H<sub>3d</sub>: The type of NAS provided to audit clients has no impact on loan officers' and professional investors' perceptions of auditor independence.*

Based on Table 6.15, it is demonstrated that the highest percentage of loan officers (72%) and professional investors (67%) believed that auditor independence would be impaired when auditors provide management functions on behalf of the clients. This result is followed by bookkeeping and other accounting services and internal audit services. The IFAC (2009) and MIA By-Laws specifically prohibit auditors from providing these services to public listed audit clients. The other types of NAS such as FISDI, assets valuation or appraisal services, actuarial services, corporate finance services, investment advice, dispute resolution services and tax services (which involve calculation for preparing accounting entries) were also perceived by the respondents in both groups as impairing auditor independence. The results of the one-sample WSRT are significant for all these services and thus support the descriptive findings.

Despite the above findings, the results of the one-sample WSRT for the loan officers are not significant for two types of NAS, namely: litigation support services and human resource services. As for the professional investors, tax services which involved tax compliance and planning services were not perceived as significantly threatening auditor independence.

<b>Table 6.15: Respondents' Perceptions of Different Types of NAS</b>								
	<b>Loan Officers (n = 110)</b>			<b>Professional Investors (n = 67)</b>			<b>One-Sample WSRT (test value = 3)</b>	
	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Loan Officers (Sig)</b>	<b>Prof. Investors (Sig)</b>
Bookkeeping and other accounting services	15.5%	18.2%	66.3%	10.4%	25.4%	64.2%	0.000*	0.000*
Financial information system design and implementation (FISDI)	20%	35.5%	44.5%	10.5%	37.3%	52.2%	0.001*	0.000*
Assets valuation or appraisal services	11.0%	24.5%	64.5%	7.5%	40.3%	52.2%	0.000*	0.000*
Actuarial services	18.2%	44.5%	37.3%	10.5%	58.2%	31.3%	0.008*	0.006*
Corporate finance services	20.2%	32.1%	47.7%	9.0%	46.2%	44.8%	0.000*	0.000*
Human resources (i.e. recruitment of senior management)	22.7%	46.4%	30.9%	16.4%	43.3%	40.3%	0.110	0.005*
Investment advice	17.3%	38.2%	44.5%	7.5%	50.7%	41.8%	0.000*	0.000*
Internal audit services	12.7%	21.8%	65.5%	7.5%	37.3%	55.2%	0.000*	0.000*
Litigation support services (i.e. expert witness)	24.6%	42.7%	32.7%	10.4%	41.8%	47.8%	0.220	0.000*
Dispute resolution services	17.3%	49.1%	33.6%	9.0%	44.7%	46.3%	0.028*	0.000*
Management functions (acting temporarily or permanently as a director/officer of a client)	7.3%	20.9%	71.8%	4.5%	28.3%	67.2%	0.000*	0.000*
Tax services – calculation for preparing accounting entries (i.e. current and deferred tax liabilities/assets)	20.9%	30.9%	48.2%	14.9%	31.4%	53.7%	0.000*	0.001*
Tax services – tax compliance and tax planning	20.9%	35.5%	43.6%	16.4%	53.7%	29.9%	0.004*	0.310

\* Significant at the 5% level.

In order to determine whether there is a statistically significant difference in the respondents' overall perceptions of the different types of NAS, the Friedman test was conducted and the results are tabulated in Table 6.16. The results from this test show statistically significant differences in the respondents' perceptions of the thirteen types of NAS in the loan officer and professional investor datasets. Based on the mean ranks, management functions was perceived as the greatest threat to auditor independence,

followed by bookkeeping and other accounting services and internal audit services. These results support the earlier descriptive findings. Table 6.16 also reveals that, for the loan officers, litigation support services were perceived as the least threat to auditor independence, followed by human resource services and dispute resolution services. As for the professional investors, the tax services (that involve tax compliance and planning) were ranked as the least threatening, followed by actuarial services and human resource services. The results for the actuarial and tax services did not come as a surprise since the IFAC (2009) and MIA By-Laws do not specifically forbid audit firms from providing such services to audit clients.

<b>Table 6.16: Analysis of Differences in Respondents' Overall Perceptions of Different Types of NAS Using the Friedman Test</b>		
	<b>Mean Rank<sup>a</sup> (Ranking)</b>	
<b>The following types of NAS would threaten auditor independence:</b>	<b>Loan Officers (n = 110)</b>	<b>Professional Investors (n = 67)</b>
Bookkeeping and other accounting services	8.12 (3)	8.39 (2)
Financial information system design and implementation	6.55 (8)	7.25 (5)
Assets valuation or appraisal services	8.05 (4)	7.41 (4)
Actuarial services	6.18 (10)	5.84 (12)
Corporate finance services	6.95 (6)	6.66 (10)
Human resources (i.e. recruitment of senior management)	5.93 (12)	6.39 (11)
Investment advice	6.74 (7)	6.77 (7)
Internal audit services	8.25 (2)	7.64 (3)
Litigation support services (i.e. expert witness)	5.79 (13)	6.72 (8)
Dispute resolution services	6.11 (11)	6.72 (8)
Management functions (acting temporarily or permanently as a director/officer of a client)	8.83 (1)	8.67 (1)
Tax services – calculation for preparing accounting entries (i.e. current and deferred tax liabilities/assets)	6.99 (5)	7.13 (6)
Tax services – tax compliance and planning	6.50 (9)	5.41 (13)
	Chi-square = 139.434 df = 12 p = 0.000*	Chi-square = 85.501 df = 12 p = 0.000*

<sup>a</sup> The higher the mean rank, the more the respondents agreed with the above statements.

\* Significant at the 5% level.

To support further the earlier results, the Wilcoxon matched-pairs signed ranked test was undertaken to determine whether there are statistically significant differences in the perceptions of auditor independence when individual types of NAS were compared. The test was performed on the loan officer and professional investor datasets. The results for the loan officers in Table 6.17 show many statistically significant differences in the perceptions of the different types of NAS particularly between bookkeeping and other accounting services, assets valuation/ appraisal services, management functions, internal audit services and the other types of NAS. As for the professional investors sample, the results in Table 6.18 indicate significant differences between actuarial services, human resource services, management functions, tax services (that involve tax compliance and planning) and the other types of NAS.

**Table 6.17: Analysis of Differences in Respondents' Perceptions when Individual Types of NAS were Compared using the Wilcoxon Matched-Pairs Signed Rank Test for the Loan Officer Dataset**

<b>Wilcoxon Matched-Pairs Signed Rank Test (Sig. 2-tailed)</b>	FISDI	Assets valuation / appraisal services	Actuarial services	Corporate finance services	Human resources	Investment advice	Internal audit services	Litigation support services	Dispute resolution services	Management functions	Tax services – preparing accounting entries	Tax services – tax compliance and tax planning
Bookkeeping and other accounting services	0.000*	0.962	0.000*	0.009*	0.000*	0.005*	0.397	0.000*	0.000*	0.057	0.006*	0.000*
FISDI		0.000*	0.286	0.354	0.139	0.609	0.000*	0.041*	0.286	0.000*	0.650	0.648
Assets valuation or appraisal services			0.000*	0.003*	0.000*	0.001*	0.304	0.000*	0.000*	0.045*	0.006*	0.001*
Actuarial services				0.056	0.307	0.208	0.000*	0.202	0.642	0.000*	0.197	0.670
Corporate finance services					0.030*	0.555	0.000*	0.006*	0.073	0.000*	0.771	0.223
Human resources						0.037*	0.000*	0.731	0.499	0.000*	0.033*	0.216
Investment advice							0.000*	0.007*	0.073	0.000*	0.919	0.314
Internal audit services								0.000*	0.000*	0.239	0.000*	0.000*
Litigation support services									0.123	0.000*	0.012*	0.097
Dispute resolution services										0.000*	0.071	0.479
Management functions											0.000*	0.000*
Tax services – calculation for preparing accounting entries												0.048*

\* Significant at the 5% level.

■ p-value > 0.05    □ p-value < 0.05

**Table 6.18: Analysis of Differences in Respondents' Perceptions when Individual Types of NAS were Compared using the Wilcoxon Matched-Pairs Signed Rank Test for the Professional Investor Dataset**

<b>Wilcoxon Matched-Pairs Signed Rank Test (Sig. 2-tailed)</b>	FISDI	Assets valuation / appraisal services	Actuarial services	Corporate finance services	Human resources	Investment advice	Internal audit services	Litigation support services	Dispute resolution services	Management functions	Tax services – preparing accounting entries	Tax services – tax compliance and tax planning
Bookkeeping and other accounting services	0.020*	0.146	0.000*	0.054	0.000*	0.058	0.381	0.027*	0.023*	0.203	0.017*	0.000*
FISDI		0.617	0.001*	0.506	0.029*	0.721	0.216	0.354	0.311	0.003*	0.434	0.000*
Assets valuation or appraisal services			0.000*	0.165	0.034*	0.375	0.394	0.133	0.117	0.017*	0.320	0.000*
Actuarial services				0.005*	0.588	0.013*	0.000*	0.037*	0.033*	0.000*	0.059	0.142
Corporate finance services					0.307	0.827	0.040*	0.948	0.956	0.001*	0.992	0.002*
Human resources						0.198	0.007*	0.172	0.152	0.000*	0.183	0.102
Investment advice							0.041*	0.635	0.635	0.003*	0.885	0.003*
Internal audit services								0.023*	0.018*	0.019*	0.143	0.000*
Litigation support services									1.000	0.000*	0.869	0.003
Dispute resolution services										0.000*	0.821	0.002*
Management functions											0.003*	0.000*
Tax services – calculation for preparing accounting entries												0.000*

\* Significant at the 5% level.

■ p-value > 0.05    □ p-value < 0.05

Based on the above results, Hypothesis 3c is rejected as it appears that the different types of NAS affect independence perceptions differently. The results of the Friedman test indicate that there is a statistically significant difference in the respondents' perceptions of the different types of NAS. The findings of the Wilcoxon matched-pair signed rank tests confirm the result of the Friedman test. Thus, it can be concluded that types of NAS *do* have an impact on the loan officers' and professional investors' perceptions of auditor independence.

In the next section, responses to the questionnaire survey relating to auditors' employment with audit clients will be presented.

## **6.6 Respondents' Perceptions of Auditors' Employment with Audit Clients**

Table 6.19 presents loan officers' and professional investors' perceptions of auditor independence when auditors seek appointment with audit clients. The hypothesis tested is as follows:

*H<sub>4a</sub>: The practice of ex-auditors seeking employment with their audit clients will not affect loan officers' and professional investors' perceptions of auditor independence.*

The results in Table 6.19 indicate that a vast majority of loan officers (66%) and professional investors (63%) were concerned about the ability of a senior auditor to remain independent when he/she seeks employment with an audit client. The respondents also seemed concerned about the independence of the last audit of the client's financial statements that a senior auditor conducts prior to joining the clients' company and the independence of the audit engagement team after their senior auditor has joined a client company. Based on the percentage of responses, the results suggest that the respondents were most concerned about the independence of the auditors who seeks employment with an audit client as compared to the last audit conducted and subsequent to joining the audit client. The results of the one-sample WSRT confirm the descriptive findings since



significant differences were found between both samples' medians and 3 for the three statements.

Table 6.19 also reveals that 38% of the loan officers considered the ex-auditors' employment issue before deciding whether they would lend to a company. On the other hand, only one-quarter of the professional investors considered the issue of ex-auditor employment with a client company. When asked whether the respondents' lending or investment decisions would be affected if they were to know that a company were hiring its auditor, the results indicate that 38% of the loan officers believed that their decisions would be affected whereas only 28% of the professional investors agreed with the statements. These differences may suggest that the loan officers are more worried than the professional investors about the consequences of the practice of ex-auditors seeking employment with their audit clients. The results of the one-sample WSRT are significant for the loan officer group but not significant for the professional investor group, confirming the descriptive findings.

As the results of the one-sample WSRT indicate the tendency of the respondents to be concerned about the independence of a senior auditor who seeks employment with his/her current audit client, Hypothesis 4a is rejected. Therefore, it can be concluded that the practice of auditors seeking employment with their audit clients *does* have an impact on the respondents' perceptions of auditor independence.

<b>Table 6.19: Respondents' Perceptions of Auditors' Employment with an Audit Client</b>								
	<b>Loan Officers (n = 110)</b>			<b>Professional Investors (n = 67)</b>			<b>One-Sample WSRT (test value = 3)</b>	
	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Loan Officers (Sig)</b>	<b>Prof. Investors (Sig)</b>
I am <b>concerned</b> about the independence of: <ul style="list-style-type: none"> <li>• a senior auditor who seeks employment with his/her current audit client.</li> </ul>	9.1%	24.5%	66.4%	7.4%	29.9%	62.7%	0.000*	0.000*
<ul style="list-style-type: none"> <li>• the last audit of the client's financial statements that the senior auditor has conducted prior to joining the client company.</li> </ul>	7.3%	26.3%	66.4%	9.0%	34.3%	56.7%	0.000*	0.000*
<ul style="list-style-type: none"> <li>• the remaining audit engagement team in their future audits after their senior auditor joins the client company.</li> </ul>	10.0%	38.2%	51.8%	7.5%	37.3%	55.2%	0.000*	0.000*
In deciding whether to lend/invest in a company, I consider whether any of the senior employees of the company has previously worked with its current auditor.	22.7%	39.1%	38.2%	44.8%	29.8%	25.4%	0.033*	0.161
If a company hires a senior employee from its audit firm, my lending/ investment decisions for the company will be affected.	20.9%	40.9%	38.2%	14.9%	56.7%	28.4%	0.018*	0.114

\* Significant at the 5% level.

### 6.6.1 Respondents' Perceptions of Auditors' Prior Position in the Audit Firm and Subsequent Position at the Client's Company

Table 6.20 reports respondents' perceptions of whether auditor independence in appearance is affected by auditors' prior positions in their audit firm and their subsequent positions at the client company. The hypotheses that relate to ex-auditors' prior position at audit firms and subsequent position at a client company are as follows:

*H<sub>4b</sub>: There is no significant difference in the respondents' perceptions of auditor independence when the ex-auditor was an audit partner and not an audit partner.*

*H<sub>4c</sub>: There is no significant difference in the respondents' perceptions of auditor independence when the ex-auditor's subsequent position at a client company involves and does not involve preparation of the company's accounts.*

The results in Table 6.20 show that the majority of respondents in both groups agreed with the statement that auditors' prior supervisory position such as audit partners would threaten the independence of the remaining audit engagement team when the auditor joins a client company. On the other hand, if the auditor was not an audit partner, the percentage of respondents who believed that auditor independence would be threatened decreased considerably. These findings provide further support for the negative perceptions when companies employ employees or owners of their audit firms. The results of the one-sample WSRT, however, indicate that both groups of respondents tend to agree that an ex-audit senior (who is not an audit partner) working for an audit client would also threaten the independence of the remaining audit engagement team. This finding somehow proves that some respondents are also worried about the independence of the remaining team members because ex-audit seniors (non-audit partners) working for audit clients could still influence their audit decisions.

Table 6.20 further revealed the respondents agreement that when the auditor's current responsibility at the client company involved preparation of company accounts, the ability of the remaining auditors to stay independent would be affected. When the senior auditor's current responsibility does not involve preparation of the company's accounts, the percentage of respondents who agreed with the statement decreased substantially. For the first statement, the results of the one-sample WSRT are significant; they show the tendency of the respondents to agree with the statement. As for the second statement, the result of the one-sample WSRT for the professional investors is significant but it may indicate their tendency to disagree with the statement (median = 3, mean = 2.73) while the loan officers seemed unaffected.

<b>Table 6.20: Respondents' Perceptions of Auditor's Prior Position in the Audit Firm and Subsequent Position at the Client Company</b>								
	<b>Loan Officers (n = 110)</b>			<b>Professional Investors (n = 67)</b>			<b>One-Sample WSRT (test value = 3)</b>	
	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Loan Officers (Sig)</b>	<b>Prof. Investors (Sig)</b>
When a senior auditor joins a client company, the independence position of the remaining audit engagement team in their future audits would be <b>threatened</b> if: • The senior auditor had been an audit partner.	10.0%	30.9%	59.1%	9.0%	26.9%	64.1%	0.000*	0.000*
• The senior auditor was a member of the engagement team, but not an audit partner.	10.0%	55.5%	34.5%	11.9%	44.8%	43.3%	0.000*	0.000*
• The senior auditor's current responsibility at the client company involved preparation of company's accounts.	6.4%	29.1%	64.5%	9.0%	31.3%	59.7%	0.000*	0.000*
• The senior auditor's current responsibility at the client company does <u>not</u> involve preparation of the company's accounts.	23.6%	53.6%	22.8%	37.3%	49.3%	13.4%	0.704	0.015* <sup>#</sup>

\* Significant at the 5% level.

<sup>#</sup> The mean responses was 2.73 and the median was 3.

Further analysis of the results was also conducted using the Wilcoxon matched-pairs signed rank test to determine whether there is a statistically significant difference in the respondents' perceptions between the two auditors' prior positions as audit partners and non-audit partners and between the auditors' subsequent position at the client company involving and not involving preparation of the company's accounts. The test was conducted on both the loan officer and professional investor samples. The results of the test are shown in Table 6.21.

The results in Table 6.21 show statistically significant differences in the respondents' perceptions between the auditors' prior positions as audit partners and non-audit partners and between their current positions at the client company that involved and does not

involve preparation of the company's accounts. Based on these results, Hypotheses 4b and 4c are rejected.

Table 6.21: Analysis of Differences in Respondents' Perceptions between Auditors' Prior Positions and Current Positions at the Client Company		
Wilcoxon Matched-Pairs Signed Rank Test		
Pairs	Loan Officers (n = 110)	Professional Investors (n = 67)
(b)&(a)	$z = -4.251, p = 0.000^*$	$z = -4.235, p = 0.000^*$
(d)&(c)	$z = -6.314, p = 0.000^*$	$z = -5.485, p = 0.000^*$
<p>* Significant at the 5% level.</p> <p>When a senior auditor joins a client company, the independence position of the remaining audit engagement team in their future audits would be <b>threatened</b> if:</p> <p>(a) the senior auditor had been an audit partner,</p> <p>(b) the senior auditor had been a member of the audit engagement team, but not audit partner,</p> <p>(c) the senior auditor's current responsibility at the client company involved preparation of company's accounts,</p> <p>(d) the senior auditor's current responsibility at the client company does <u>not</u> involve preparation of the company's accounts.</p>		

## 6.6.2 Respondents' Perceptions regarding the Sufficiency of a 2-Year Cooling-off Period

Table 6.22 reports loan officers' and professional investors' perceptions of the sufficiency of a cooling off period of two years that audit firms must observe before an audit partner joins an audit client as a safeguard to auditor independence. The hypothesis to be tested is as follows:

*H<sub>4d</sub>: A 'cooling-off' period of 2 years that audit firms must observe before audit partners join an audit client is not sufficient to safeguard auditor independence from problems that may arise due to employment with audit clients.*

Table 6.22 reveals that the majority of loan officers were satisfied with the 2-year cooling-off period as a safeguard to auditor independence. It can also be observed that a higher

percentage of loan officers (59%) agreed with the 2-year cooling-off period as compared to the professional investors (42%). This may be because relatively more loan officers consider auditors' employment factors before making lending decisions and may thus place higher confidence in the 2-year cooling-off period as a safeguard to auditor independence than do the professional investors. The results of the current study also indicate support for the MIA's regulation forbidding audit firms from performing an audit for a listed client unless a 2-year period has passed since the ex-auditor acted as the audit engagement partner for that listed client. The result of the one-sample WSRT for the loan officers is significant which means that there is a tendency for the loan officers to agree with the current cooling-off period. The WSRT result for the professional investors group, however, is not significant.

Of those respondents who indicated their disagreement that the current cooling-off period is sufficient to protect auditor independence, a majority of them voiced their concern about the consequences of ex-auditor employment by indicating that the cooling-off period should be longer, that is, more than three years (most of them stated that it should be five years). A further 20% of loan officers and 12% of professional investors indicated that it should be a 3-year cooling-off period. Only a few indicated that it should be less than two years.

Hypothesis 4d is rejected, but only for the loan officer dataset as the results of the one-sample WSRT suggest that only the loan officers tended to agree with the 2-year cooling-off period. For the professional investors, the result is insignificant and thus fails to reject the null hypothesis.

<b>Table 6.22: Respondents' Perceptions of Sufficiency of a Cooling-off Period of 2 Years</b>								
	<b>Loan Officers (n=110)</b>			<b>Professional Investors (n=67)</b>			<b>One-Sample WSRT (test value = 3)</b>	
	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Loan Officers (Sig)</b>	<b>Prof. Investors (Sig)</b>
A 2-year cooling-off period before an audit partner could join a client company is sufficient to safeguard auditor independence.	17.3%	23.6%	59.1%	25.4%	32.8%	41.8%	0.000*	0.123
* Significant at the 5% level.								
<b>Of those who disagreed that the 2-year cooling-off period is sufficient:</b>	<b>Loan Officers (n = 20)</b>		<b>Professional Investors (n = 17)</b>					
It should be 1 year	5%		12%		N/A			
It should be 1 ½ years	5%		0%		N/A			
It should be 2 ½ years	5%		0%		N/A			
It should be 3 years	20%		12%		N/A			
It should be > than 3 years	60%		76%		N/A			

## 6.7 Respondents' Perceptions of Audit Committee

The review of the literature in Chapter 2 revealed that the existence of an audit committee enhanced perceptions of auditor independence. The hypotheses that relate to the existence of audit committees are as follows:

*H<sub>5a</sub>: The existence of audit committees responsible for the appointment and reappointment of external auditors will not affect loan officers' and professional investors' perceptions of auditor independence.*

*H<sub>5b</sub>: The existence of audit committees responsible for review and approval of audit fees will not affect loan officers' and professional investors' perceptions of auditor independence.*

*H<sub>5c</sub>: The existence of independent audit committees will not affect loan officers' and professional investors' perceptions of auditor independence.*

- H<sub>5d</sub>: The existence of at least one audit committee member with accounting and financial expertise will not affect loan officers' and professional investors' perceptions of auditor independence.*
- H<sub>5e</sub>: The existence of active audit committees will not affect loan officers' and professional investors' perceptions of auditor independence.*
- H<sub>5f</sub>: The existence of compulsory audit committee reports in the annual reports of a listed company will not affect loan officers' and professional investors' perceptions of auditor independence.*
- H<sub>5g</sub>: Loan officers' and professional investors' perceptions of auditor independence will not be affected when external auditors report to and are monitored by the audit committee.*

The results in Table 6.23 reveal that a clear majority of loan officers believed that all audit committee's characteristics may safeguard auditor independence. A huge majority of loan officers (84%) and professional investors (67%) agreed that auditor independence would be safeguarded if at least one member of the committee has accounting and financial expertise. Based on the mean score, this characteristic was ranked highest.

A high percentage of loan officers (85%) and professional investors (72%) also agreed with the statement; 'the existence of an audit committee may safeguard auditor independence if there is a compulsory audit committee report that described the committee's activities and actions taken during the year'. This characteristic was also ranked highly by the respondents. The high level of agreement between the respondents might indicate their confidence in the benefits of having a report which would provide users with a better understanding of the committee's oversight role in the financial reporting process. Since the roles of an audit committee have been enhanced with more responsibilities have been entrusted, the respondents may also feel that it is essential for the audit committee to report what they have done rather than just reporting what they should be doing as stated in their term of reference.



A high percentage of loan officers (84%) and professional investors (69%) also believed that auditor independence would be safeguarded when external auditors report to and are monitored by the audit committee. This characteristic was ranked 2<sup>nd</sup> and 3<sup>rd</sup> by the loan officers and professional investors respectively as audit committees' characteristic that may safeguard independence. This result is also consistent with the SOX 2002 which requires the timely reporting of specific information by auditors to audit committees including critical accounting policies and practices used by the audit clients.

The independence of an audit committee is also critical in ensuring that it can deliver its responsibilities objectively. The survey results reveal that the presence of an independent audit committee would help in safeguarding auditor independence. Since the audit committee is not associated with the company as an officer or an employee, they may be able to perform to their duties effectively. Sori et al. (2001) dictated that an audit committee member without any financial, family or any material ties to management is more likely to be able to evaluate objectively the propriety of management accounting, internal control and reporting practices.

Similarly, it can also be seen that an overwhelming majority of respondents in both groups believed that auditor independence would be enhanced when the audit committees are responsible for the appointment and re-appointment of the external auditors. These findings support Goldman and Barlev's (1974) contention that the management power over the auditors would be limited if audit committees were established to deal with the selection of auditors and involved in matters involving auditors' replacement.

In the previous section, the results regarding auditors' financial dependence showed a strong concern that a heavy reliance on audit fees would impair auditor independence. An audit committee could play a major role in ensuring that companies pay an appropriate amount of audit fees to their auditors. Table 6.23 shows that the majority of loan officers (79%) and professional investors (70%) believed that auditor independence would be safeguarded when audit committees review and approve audit fees. These findings also support Goldman and Barlev's (1974) argument that the management's influence over the

auditors would be limited if audit committees were to deal with matters related to the negotiation of audit fees.

Finally, the results also indicate that the majority of the loan officers (76%) and professional investors (55%) agreed that an active audit committee would safeguard auditor independence. The activeness of the audit committee, however, was ranked the lowest as the audit committees' characteristic that may safeguard auditor independence. Nevertheless, the positive responses shown by the majority of the respondents provide support for Sori et al.'s (2009) suggestion that the more meetings held by the committee indicate that members are putting more effort into monitoring business transactions and ensuring that the internal control is working as intended. This is also expected to serve as a safeguard for good financial reporting.

Table 6.23 also indicates that the results of the one-sample WSRT are significant for all the statements which suggest that respondents tend to agree that all audit committees' characteristics may safeguard auditor independence, thus confirming the descriptive findings. Based on these results, all the hypotheses related to audit committee (Hypotheses 5a - 5g) are rejected.

<b>Table 6.23: Respondents' Perceptions of the Existence of an Audit Committee</b>												
	<b>Loan Officers (n = 110)</b>					<b>Professional Investors (n = 67)</b>					<b>One-Sample Wilcoxon Signed Rank Tests (test value = 3)</b>	
	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Mean</b>	<b>Ranking</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Mean</b>	<b>Ranking</b>	<b>Loan Officers (Sig)</b>	<b>Prof. Investors (Sig)</b>
In my opinion, the existence of an <b>audit committee</b> may safeguard auditor independence if :	1.8%	21.8%	76.4%	3.76	7	0.0%	44.8%	55.2%	3.66	7	0.000*	0.000*
(a) They are active, by holding more than 3 meetings a year.												
(b) They are responsible for the appointment and re-appointment of the external auditor.	4.5%	14.6%	80.9%	3.81	5	1.5%	29.8%	68.7%	3.84	6	0.000*	0.000*
(c) They review and approve audit fees.	2.7%	18.2%	79.1%	3.80	6	3.0%	26.9%	70.1%	3.85	4	0.000*	0.000*
(d) They are composed of a <b>majority</b> of independent and non-executive directors.	4.5%	18.2%	77.3%	3.84	4	1.5%	35.8%	62.7%	3.85	4	0.000*	0.000*
(e) At least one member of the audit committee has accounting and financial expertise.	2.8%	13.6%	83.6%	4.00	1	0.0%	32.8%	67.2%	4.00	1	0.000*	0.000*
(f) There is a compulsory audit committee report that describes their activities and actions taken during the year.	3.6%	11.8%	84.6%	3.9	3	0.0%	28.4%	71.6%	3.96	2	0.000*	0.000*
(g) The external auditors report to and are monitored by the audit committee.	3.7%	12.7%	83.6%	3.92	2	0.0%	31.3%	68.7%	3.91	3	0.000*	0.000*

\* Significant at the 5% level.

Table 6.24 shows respondents' responses as to whether they take into consideration of any of the audit committee's characteristic(s) in making lending/investing decisions.

<b>Table 6.24: Respondents' Responses as to Whether They Consider Any of the Audit Committee's Characteristic(s) in their Lending/Investing Decisions</b>				
	<b>Loan Officers (n = 110)</b>		<b>Professional Investors (n = 67)</b>	
	<b>Yes</b>	<b>No</b>	<b>Yes</b>	<b>No</b>
Do you consider any of audit committee's characteristic(s) in making lending/investment decisions?	59%	41%	29%	71%
<b>If 'Yes', which audit committee's characteristic(s) do you consider:</b>	<b>Loan Officers (n = 69)</b>		<b>Professional Investors (n = 26)</b>	
(a) They are active, by holding more than 3 meetings a year.	20.0%		11.5%	
(b) They are responsible for the appointment and re-appointment of the external auditor.	27.5%		11.5%	
(c) They review and approve audit fees.	14.5%		11.5%	
(d) They are composed of a <u>majority</u> of independent and non-executive directors.	46.4%		46.0%	
(e) At least one member of the audit committee has accounting and financial expertise.	47.8%		23.1%	
(f) There is a compulsory audit committee report that describes their activities and actions taken during the year.	24.6%		50.0%	
(g) The external auditors report to and are monitored by the audit committee.	37.8%		15.0%	

The results in Table 6.24 disclose that 59% of the loan officers considered at least one characteristic of an audit committee in making lending decisions. However, the majority of professional investors did not at all consider the characteristics of an audit committee in making investment decisions. These findings seem to suggest that the loan officers placed greater importance in the audit committee's roles or characteristics in their loan assessments. Of the loan officers who considered audit committee's characteristics, most of them considered the audit committee's financial expertise as well as its independence in making lending decisions. As for the professional investors, the majority of them first

considered the compulsory audit committee report in making investing decisions, followed by that characteristic whereby the committee comprises a majority of independent and non-executive directors. Some of the loan officers and professional investors also indicated that they considered other factors such as an active audit committees, the committee's responsibility for the appointment and reappointment of external auditors, the committee's role to review and approve audit fees as well as the characteristic whereby the auditors should report to and monitored by the audit committee.

The results of respondents' perceptions of other safeguards to auditor independence will be discussed in the following section.

## **6.8 Respondents' Perceptions of Other Safeguards to Auditor Independence**

In this section, the impacts of other safeguards that have been reported in the literature and suggested by the profession, on perceptions of auditor independence are examined. Table 6.25 reports respondents' perceptions of other safeguards to auditor independence.

The results in Table 6.25 reveal that the majority of loan officers (75%) and professional investors (61%) agreed that a greater disclosure on NAS and non-audit fees paid to an external auditor could safeguard auditor independence. As mentioned in the literature review, the perceived impact of such disclosure on auditor independence has not been widely examined even though in the case of Malaysia the disclosure for all listed companies was made compulsory in 2001. Based on the above results, it can be suggested that the respondents are confident in the benefits of disclosing non-audit fees and NAS provided by auditors to their audit clients. These findings also seem to support the earlier conclusion where it was found that the threat to auditor independence reduced significantly if full disclosures were made in the client's financial statement and the same personnel were involved in the audit.

With regard to banning any senior auditor from seeking employment with audit clients, Table 6.25 indicates split results for the loan officer group. Just above 39% of the loan

officers were neutral while 32% of them disagreed with the policy of banning senior auditors from working with their audit clients. A much higher level of disagreement was shown by the professional investors (46%). These results are supported by the results of the one-sample WSRT as a significant difference is only found for the professional investors' group which indicates that this group tends to disagree with the statement. The loan officers' result is not significant which means that they tend to be unaffected by the banning of any senior auditor from seeking employment with audit clients. This might reflect that the respondents from the professional investor group believed in the benefits of an employment relationship between the ex-auditors and the client company. Since former auditors are more familiar with their client's business strategy and financial reporting processes, the benefits of hiring the former auditors outweigh those of hiring individuals from outside the audit firm and this situation may be one of the reasons the professional investors expressed concerns about auditors being banned from seeking employment with their clients.

Another safeguard to auditor independence relates to systematic rotation within the audit firms among their audit staff. It can be seen that although a large majority of loan officers (76%) believed that a rotation of staff could safeguard independence, a much lower level of agreement was shown by the professional investors (49%). This finding might reflect the loan officers' confidence in the benefits that the systematic staff rotation might bring in enhancing auditor independence. Since the rotation of audit partners is already in place in many countries, an additional measure such as staff rotation could further safeguard auditor independence.

Other safeguards to auditor independence owing to problems with ex-auditors' employment are: conducting an independent review of the work of the departing audit senior and implementing a policy within audit firms for peer review. Table 6.25 reveals that the majority of respondents agreed that an independent review of the departing auditors' work by another audit senior could help in safeguarding independence. Similarly, most of the respondents believed that audit firms should have policies for peer reviews on significant audit decisions. Since the percentage of agreement among the loan officers is much higher than that among professional investors, it may indicate the loan officers'

belief that the quality of audit would be maintained if the auditors' work were reviewed by a panel of experts from another accounting firm. However, one of the limitations of such a policy is the additional cost involved in the process and this might be one of the reasons the level of agreement is lower among the professional investors.

The questionnaire also attempted to elicit respondents' perceptions as to whether a peer review program enforced by the relevant regulatory authority which focuses on audit firms' compliance with audit and ethical standards could safeguard auditor independence. The results reflected by both groups of respondents are consistent with the earlier results concerning audit firms' policy for peer reviews.

Table 6.25 also shows results testifying to respondents' perceptions of auditor independence when regular inspections of the audit documents of public listed companies are conducted by the regulatory authority. Similar to other safeguards, a vast majority of respondents from both groups believed that such an action by the regulatory authority could help protect auditor independence. The recent establishment of the AOB in Malaysia will lead to routine inspections of audit working papers, books and accounts of public listed companies. The finding of the study might indicate the respondents' belief that the auditors' standard of work will increase when they are subject to regular independent review. The results therefore reflect the respondents' confidence in the benefits that the recent audit oversight reform might bring.

Table 6.25 reveals that the highest percentage of loan officers (86%) and professional investors (81%) agreed that immediate investigations on auditors suspected of non-compliance with audit and ethical standards could safeguard auditor independence. On the other hand, when investigations of auditors were conducted only upon complaints by the public or referrals by other authorities, the percentage of respondents from both sets who agreed that it will safeguard independence declined drastically. The decline in the percentage of agreement might indicate the respondents' concern that the authority is not doing enough if they have to wait for complaints to initiate actions on auditors who are suspected of non-compliance with the standards.

Table 6.25: Respondents' Perceptions of Other Safeguards to Auditor Independence								
	Loan Officers (n=110)			Professional Investors (n=67)			One-Sample WSRT (test value = 3)	
	Disagree	Neutral	Agree	Disagree	Neutral	Agree	Loan Officers (Sig)	Prof. Investors (Sig)
The following actions could <b>safeguard</b> auditor independence: <ul style="list-style-type: none"> <li>• Greater disclosure on non-audit services and non-audit fees paid to external auditor.</li> </ul>	4.6%	20.9%	74.5%	0.0%	38.8%	61.2%	0.000*	0.000*
<ul style="list-style-type: none"> <li>• A total ban on allowing any senior auditor from seeking employment with an audit client.</li> </ul>	31.8%	39.1%	29.1%	46.3%	38.8%	14.9%	0.748	0.028*
<ul style="list-style-type: none"> <li>• A systematic staff rotation within the audit firms.</li> </ul>	7.2%	17.3%	75.5%	3.0%	47.7%	49.3%	0.000*	0.000*
<ul style="list-style-type: none"> <li>• An independent review of the departing audit senior's work by another audit senior (who is not a member of the audit engagement team)</li> </ul>	2.8%	33.0%	64.2%	1.5%	47.8%	50.7%	0.000*	0.000*
<ul style="list-style-type: none"> <li>• Audit firms should have policies for peer reviews on significant audit decisions.</li> </ul>	2.7%	18.2%	79.1%	0.0%	41.8%	58.2%	0.000*	0.000*
The following actions by the relevant <b>regulatory authority</b> could <b>safeguard</b> auditor independence: <ul style="list-style-type: none"> <li>• A peer review program that focuses on audit firms' compliance with audit and ethical standards.</li> </ul>	2.7%	19.1%	78.2%	1.5%	37.3%	61.2%	0.000*	0.000*
<ul style="list-style-type: none"> <li>• Regular inspections of audit documents of public listed companies.</li> </ul>	2.8%	13.7%	83.5%	0.0%	23.9%	76.1%	0.000*	0.000*
<ul style="list-style-type: none"> <li>• Immediate investigations on auditors suspected of non-compliance with audit and ethical standards.</li> </ul>	0.9%	13.6%	85.5%	0.0%	19.4%	80.6%	0.000*	0.000*
<ul style="list-style-type: none"> <li>• Investigations on auditors suspected for violation of audit or ethical standards <u>only</u> upon complaints by the public or referrals by other authorities.</li> </ul>	19.1%	21.8%	59.1%	19.4%	49.3%	31.3%	0.000*	0.091*
<ul style="list-style-type: none"> <li>• Disciplinary actions and sanctions are imposed on auditors who fail to comply with audit and ethical standards.</li> </ul>	1.8%	12.7%	85.5%	0.0%	22.4%	77.6%	0.000*	0.000*

\* Significant at the 5% level.



With regard to taking disciplinary actions and imposing sanctions on auditors who fail to comply with audit and ethical standards, it can be observed in Table 6.25 that a large majority of respondents from both groups also agreed that such actions could help in safeguarding auditor independence. This finding might indicate the respondents' belief that auditors would act more independently when they are aware of disciplinary actions and sanctions from the accounting bodies or other regulatory authority.

Further tests using the Wilcoxon matched-pairs signed rank test were conducted on the loan officer and professional investor datasets in order to determine: 1) which peer review program (either through audit firms' policy or regulatory authority requirement); and 2) whether immediate investigations on auditors suspected of non-compliance with the standards or investigations of auditors were conducted only upon complaints, were considered to offer better safeguards for auditor independence. Based on the results in Table 6.26, it can be concluded that there is no significant difference in the respondents' perceptions between the two peer review programs in both datasets tested. This might indicate that the respondents show no preference and that both peer review programs may be viewed as equally able to safeguard auditor independence. However, the results from the test show that there are statistically significant differences between the two types of investigation into auditors in the loan officer and professional investor samples tested, confirming the earlier results.

<b>Table 6.26: Analysis of Differences in Respondents' Perceptions between Peer Review Programs and Investigations on Auditors</b>		
<b>Wilcoxon Matched-Pairs Signed Rank Test</b>		
<b>Pairs</b>	<b>Loan Officers (n = 110)</b>	<b>Professional Investors (n = 67)</b>
(b)&(a)	$z = -0.153, p = 0.879$	$z = -0.728, p = 0.467$
(d)&(c)	$z = -4.921, p = 0.000^*$	$z = -5.595, p = 0.000^*$
<p>* Significant at the 5% level.</p> <p>The following actions could <b>safeguard</b> auditor independence:</p> <p>(a) audit firms' policy for peer review program</p> <p>(b) regulator's peer review program</p> <p>(c) immediate investigation on auditors suspected of non-compliance with audit and ethical standards</p> <p>(d) investigations on auditors were conducted only upon complaints by the public or referrals.</p>		

Table 6.27 shows respondents' perceptions of the regulatory body that should regulate the accounting profession. As mentioned in Chapter 3, the AOB was recently established to oversee the auditors of public interest entities in Malaysia.

<b>Table 6.27: Respondents' Perceptions of the Regulatory Body that Should Regulate Auditors of Public Listed Companies</b>								
	<b>Loan Officers (n=110)</b>			<b>Professional Investors (n=67)</b>			<b>One-Sample WSRT (test value = 3)</b>	
	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Loan Officers (Sig)</b>	<b>Prof. Investors (Sig)</b>
In my opinion, auditors of public listed companies should be regulated by:								
• The accounting profession (i.e the Malaysian Institute of Accountants or other professional accounting bodies).	0.0%	8.2%	91.8%	1.5%	17.9%	80.6%	0.000*	0.000*
• The Audit Oversight Board.	1.8%	22.7%	75.5%	1.5%	31.3%	67.2%	0.000*	0.000*

\* Significant at the 5% level

The results in Table 6.27 indicate that a clear majority of loan officers and professional investors believed that both the accounting profession and the AOB should regulate auditors of public listed companies. The results of the one-sample WSRT are significant,

indicating the tendency of the respondents to agree with both statements. However, the percentage of respondents who preferred the AOB is lower than those who preferred the accounting profession. The Wilcoxon matched-pairs signed rank test was performed on the loan officer and professional investor datasets. The results in Table 6.28 show that there is a significant difference between the responses for the accounting profession and those for the AOB in the loan officer dataset. These findings might suggest that the majority of the loan officers still believed that the accounting profession should continue to regulate the auditors of public listed companies and have more confidence in its ability to safeguard and promote auditor independence than the AOB. However, this could also mean that they were unfamiliar with the functions of the AOB since it is only recently established and they may have less confidence in its ability as a new body to regulate the auditors of public listed companies.

**Table 6.28: Analysis of Differences in Respondents' Perceptions between the Regulation of Auditors of Listed Companies by the Accounting Profession and the Audit Oversight Board**

Wilcoxon Matched-Pairs Signed Rank Test		
Pairs	Loan Officers (n = 110)	Professional Investors (n = 67)
(b)&(a)	$z = -4.825, p = 0.000^*$	$z = -0.815, p = 0.415$
<p>* Significant at the 5% level.</p> <p>Auditors of public listed companies should be regulated by:</p> <p>(a) the accounting profession</p> <p>(b) the Audit Oversight Board.</p>		

## 6.9 Respondents' Perceptions of Importance of Audit Report

Abu Bakar et al. (2005) stated that respondents' confidence in the credibility of the accounting profession could be reflected by how important they perceive an audit report to be in making business decisions. Table 6.29 reports respondents' perceptions as to the importance of an audit report. The respondents were asked to express their perceptions based on a five-point Likert scale, ranging from 'not important at all' to 'very important', which was later condensed to a three-point scale for presentation.

<b>Table 6.29: Respondents' Perceptions of the Importance of Audit Report</b>						
	<b>Loan Officers (n = 110)</b>			<b>Professional Investors (n = 67)</b>		
	<b>Not Important</b>	<b>Neutral</b>	<b>Important</b>	<b>Not Important</b>	<b>Neutral</b>	<b>Important</b>
How important do you think an audit report is in making lending/investing decisions?	0%	2.7%	97.3%	1.5%	12%	86.5%
<b>One-Sample Wilcoxon Signed Ranks Tests (test value = 3)</b>	0.000*			0.000*		

\* Significant at the 5% level.

As can be observed in Table 6.29, a clear majority of loan officers and professional investors believed that an audit report is important in making lending/ investing decisions. The results of the one-sample WSRT are significant and confirm the descriptive findings. The percentage of the loan officers who believed that audit report is important in decision making is higher than the percentage of the professional investors, which could mean that loan officers rely more on the audit report and its credibility than do the professional investors. Since the existence of audited financial statements (and audit reports) is one of the main requirements in loan evaluation, the loan officers rely heavily on this document as compared to the professional investors, who might prefer share price reports and other stock brokers' reports in making investment evaluations. Nevertheless, as users of an audit report, the majority of the respondents in this study still have strong confidence in the audit report and believe in the credibility of the accounting profession despite the recent fraud incidents involving several local companies and other infamous audit failures such as Enron. The results of the current study are parallel to the findings in prior studies by Abu Bakar et al. (2005) and Firth (1980). It seems that there is a slight improvement in the confidence of Malaysian loan officers in this study since none of them indicated an audit report as not important in making lending decisions while Abu Bakar et al. (2005) reported that 1.2% of the loan officers in their study perceived the audit report as 'not important'.

The next section will discuss the relationships between the background variables and respondents' perceptions of auditor independence.

## **6.10 Respondents' Background Variables and Perceptions of Auditor Independence**

As mentioned in Chapter 2, it has been argued that respondents' background variables could affect perceptions of auditor independence. In this section, the relationships are examined between the background variables such as accounting qualifications, prior working experience as an accountant in industry or auditor in accounting firm, age, gender and type of respondent and perceptions of auditor independence. The previous sections have indicated that factors such as long audit tenure, audit firms and audit partners' financial dependence, NAS and ex-auditors employment each affected respondents' perceptions of auditor independence. Therefore, the respondents' answers to those statements related to whether these factors affect their perceptions of, and confidence in, auditor independence and their lending or investing decisions were used to test the hypotheses. For the audit committee, the respondents' answers to all statements were averaged and used in these tests. The results of the tests on respondents' background variables will be presented in the following sub-sections.

### **6.10.1 Respondents' Accounting Qualifications and Perceptions of Auditor Independence**

The following hypothesis was tested using the Mann-Whitney U test in order to determine whether there is a significant difference in the perceptions of auditor independence between respondents with and without accounting qualifications:

*H<sub>6</sub>: There is no significant difference in the perceptions of auditor independence between respondents with and respondents without accounting qualifications.*

The results of the Mann-Whitney U test are presented in Table 6.30.

**Table 6.30: Analysis of Differences in Perceptions of Auditor Independence (AI) between Respondents With and Without Accounting Qualifications**

	Loan Officers (n = 110)		Professional Investors (n = 67)		Combined (n = 177)	
	Mann-Whitney	Sig.	Mann-Whitney	Sig.	Mann-Whitney	Sig.
A lengthy relationship between an auditor and a client company is a threat to AI.	1129	0.033* <sup>a</sup>	387	0.234	2922	0.024* <sup>c</sup>
A lengthy relationship with an audit client affects my confidence in an auditor's independence.	1362	0.556	360	0.114	3256	0.246
Even though an audit firm is economically dependent upon its audit client, it could still maintain its independence from that client.	1214	0.115	315	0.027* <sup>b</sup>	2876	0.016* <sup>d</sup>
When an audit partner's income is dependent on total fees generated from a single audit client, his/her ability to remain independent would be affected.	1359	0.503	465	0.935	3511	0.718
My lending/ investment decisions for a company would be affected if I perceive its auditors to be economically dependent upon it.	1385	0.661	452	0.786	3535	0.791
When an auditor provides non-audit services to an existing audit client, my confidence in the auditor's ability to remain independent would be affected.	1273	0.238	376	0.155	3507	0.719
I am concerned about the independence of a senior auditor who seeks employment with his/her current audit client.	1380	0.632	395	0.276	3301	0.304
If a company hires a senior employee from its audit firm, my lending/ investment decisions for the company will be affected.	1373	0.609	388	0.208	3284	0.276
An audit committee's existence may safeguard AI.	1281	0.286	416	0.452	3586	0.926

\* Significant at the 5% level.

<sup>a</sup> mean rank: with accounting knowledge - 62.84, without accounting knowledge - 50.61

<sup>b</sup> mean rank: with accounting knowledge - 26.23, without accounting knowledge - 37.31

<sup>c</sup> mean rank: with accounting knowledge - 99.84, without accounting knowledge - 82.86

<sup>d</sup> mean rank: with accounting knowledge - 77.45, without accounting knowledge - 95.54

As can be seen from Table 6.30, the results of the Mann-Whitney U tests indicate that, for the loan officers, there is a significant difference between those with and without accounting qualifications in their perceptions of long audit tenure as a threat to auditor independence. The mean rank of those with accounting qualifications (62.84) was higher than those without accounting qualifications (50.61), suggesting that those with

qualifications were more concerned about the threat of long tenure on auditor independence than were those without qualifications. In addition, the results also indicate that the professional investors' perceptions of audit firms' financial dependence appear to be affected by whether or not the professional investor has accounting knowledge. The mean rank of respondents without accounting qualifications (37.31) who agreed that audit firms could still maintain their independence even if economically dependent on a single audit client is higher than those with accounting qualifications (26.23). This finding suggests that the professional investors with no formal accounting knowledge were less concerned about the potential impact of audit firms' financial dependence than were those with formal accounting knowledge. These results fail to support Barton's (1980) argument that those with accounting knowledge would be less concerned about the threat to auditor independence as they would better understand auditing functions than would those without accounting knowledge.

The combined results reflect the loan officers' and professional investors' findings as it appears that the perceptions of long audit tenure and audit firms' financial dependence are affected by whether or not a respondent has accounting knowledge. The results of other factors such as NAS, ex-auditors' employment with audit clients and the existence of an audit committee are not significant. Based on these results, Hypothesis 6 can be rejected because significant differences exist in the perceptions of long audit tenure and financial dependence between respondents with and respondents without accounting qualification.

#### **6.10.2 Respondents' Prior Experience as Accountants or Auditors and Perceptions of Auditor Independence**

The hypothesis that relates to respondents' prior experience as accountants or auditors is as follows:

*H<sub>7</sub>: There is no significant difference in the perceptions of auditor independence between respondents with prior experience and respondents without prior experience in accounting firms or as accountants in industry.*

The results of the Mann-Whitney U test which examined whether there is any significant difference in the perceptions between respondents with and without prior working experience in the said positions are tabulated in Table 6.31.

<b>Table 6.31: Analysis of Differences in Perceptions of Auditor Independence (AI) between Respondents With and Without Prior Experience as Accountants or Auditors</b>						
	<b>Loan Officers (n = 110)</b>		<b>Professional Investors (n = 67)</b>		<b>Combined (n = 177)</b>	
	<b>Mann-Whitney</b>	<b>Sig.</b>	<b>Mann-Whitney</b>	<b>Sig.</b>	<b>Mann-Whitney</b>	<b>Sig.</b>
A lengthy relationship between an auditor and a client company is a threat to AI.	955	0.547	354	0.406	2461	0.298
A lengthy relationship with an audit client affects my confidence in an auditor's independence.	1003	0.822	321	0.185	2460	0.299
Even though an audit firm is economically dependent upon its audit client, it could still maintain its independence from that client.	780	0.048 <sup>*a</sup>	290	0.072	2034	0.008 <sup>*b</sup>
When an audit partner's income is dependent on total fees generated from a single audit client, his/her ability to remain independent would be affected.	867	0.161	384	0.701	2422	0.208
My lending/ investment decisions for a company would be affected if I perceive its auditors to be economically dependent upon it.	968	0.619	395	0.844	2611	0.628
When an auditor provides non-audit services to an existing audit client, my confidence in the auditor's ability to remain independent would be affected.	798	0.067	333	0.227	2573	0.526
I am concerned about the independence of a senior auditor who seeks employment with his/her current audit client.	947	0.503	396	0.846	2577	0.540
If a company hires a senior employee from its audit firm, my lending/ investment decisions for the company will be affected.	942	0.489	315	0.121	2341	0.133
An audit committee's existence may safeguard AI.	979	0.697	357	0.446	2516	0.426

\* Significant at the 5% level.

<sup>a</sup> mean rank: with prior experience - 45.02, without prior experience - 58.42

<sup>b</sup> mean rank: with prior experience - 71.35, without prior experience - 94.15



Table 6.31 shows that respondents' prior experience as accountants in industry or auditors in public practice did not have any significant impact on the professional investors' perceptions of auditor independence. However, the loan officers' perceptions of the audit firms' economic dependence on an audit client seem to be affected by whether or not the respondents have prior working experience as accountants or auditors. The results of the combined dataset also reveal a significant difference between those with and without prior working experience and their perceptions of audit firms' economic dependence. For both the loan officer and combined datasets, the mean ranks of respondents without prior working experience who agreed that audit firms could still maintain their independence even if financially dependent on an audit client are higher than those with experience as accountants or auditors. These findings fail to support Firth's (1980) contention as it seems that respondents without working experience in the said positions in this study are the ones who are less concerned about audit firms' financial dependence as compared to those who have working experience.

Except for the effect on audit firms' financial dependence, the general findings of the tests indicate that there is no significant difference in the responses between respondents with and without prior working experience as accountants or auditors. The threat of ex-auditor employment with audit clients is also not affected by whether or not the respondents have working experience in the said positions (because some of the respondents who were previously auditors may have the experience working with audit clients). Perhaps, there now exists a general awareness of how the practice of auditors seeking employment with audit clients could lead to the impairment of independence. This finding further confirms the earlier descriptive findings which revealed a high level of concern about the independence of auditors when they seek employment with an existing audit client.

Based on the above results, Hypothesis 7 is rejected, but only for the loan officer and combined datasets as significant differences are found in the perceptions of audit firms' economic dependence between respondents with previous experience and respondents without prior experience in accounting firms or as accountants in industry. For the

professional investor group, Hypothesis 7 is not rejected since the evidence presented indicates that prior working experience as accountants and auditors does not have any significant impact on perceptions of auditor independence.

### **6.10.3 Respondents' Age and Perceptions of Auditor Independence**

The following hypothesis was tested using the Kruskal-Wallis test in order to determine whether respondents' age has an impact on their perceptions of auditor independence:

*H<sub>8</sub>: There is no significant difference in the perceptions of auditor independence between respondents of different ages.*

There are four age groups of respondents in this study, namely: 30 years and less, 31-40 years, 41-50 years and 51-60 years. Rather than the Mann-Whitney test, the non-parametric test of Kruskal-Wallis was used here since it allows the current study to compare responses for three or more groups. The results of the Kruskal-Wallis tests are presented in Table 6.32. The age group with the highest mean rank score is presented in the 'Highest Mean Rank' column. It indicates the group with the highest agreement to the statements related to whether factors such as long audit tenure and NAS affect their perceptions of auditors' ability to remain independent. For the audit committee, the highest mean rank indicates the age group with the highest averaged results of all the statements related to audit committees.

<b>Table 6.32: Analysis of Differences in Perceptions of Auditor Independence (AI) between Respondents of Different Ages</b>									
	<b>Loan Officers (n = 110)</b>			<b>Professional Investors (n = 67)</b>			<b>Combined (n = 177)</b>		
	<b>Chi-Square</b>	<b>Sig.</b>	<b>Highest Mean Rank</b>	<b>Chi-Square</b>	<b>Sig.</b>	<b>Highest Mean Rank</b>	<b>Chi-Square</b>	<b>Sig.</b>	<b>Highest Mean Rank</b>
A lengthy relationship between an auditor and a client company is a threat to AI.	2.587	0.460	41-50 years	13.006	0.005*	51-60 years	10.130	0.017*	51-60 years
A lengthy relationship with an audit client affects my confidence in an auditor's independence.	1.506	0.681	51-60 years	11.979	0.007*	51-60 years	9.894	0.019*	51-60 years
Even though an audit firm is economically dependent upon its audit client, it could still maintain its independence from that client.	0.770	0.857	51-60 years	4.825	0.185	31-40 years	2.252	0.522	≤ 30 years
When an audit partner's income is dependent on total fees generated from a single audit client, his/her ability to remain independent would be affected.	0.113	0.990	≤ 30 years	6.790	0.079	51-60 years	3.209	0.360	51-60 years
My lending/ investment decisions for a company would be affected if I perceive its auditors to be economically dependent upon it.	1.639	0.650	51-60 years	6.81	0.078	51-60 years	7.315	0.063	51-60 years
When an auditor provides non-audit services to an existing audit client, my confidence in the auditor's ability to remain independent would be affected.	1.528	0.679	51-60 years	3.149	0.369	51-60 years	1.940	0.585	51-60 years
I am concerned about the independence of a senior auditor who seeks employment with his/her current audit client.	1.184	0.757	41-50 years	3.889	0.274	51-60 years	3.249	0.355	51-60 years
If a company hires a senior employee from its audit firm, my lending/ investment decisions for the company will be affected.	0.254	0.968	51-60 years	1.497	0.683	51-60 years	0.644	0.886	51-60 years
An audit committee's existence may safeguard AI.	7.584	0.055	41-50 years	16.143	0.001*	51-60 years	22.78	0.000*	41-50 years

\* Significant at the 5% level (using the Kruskal-Wallis tests).

The results in Table 6.32 show that age did not have any significant impact on loan officers' perceptions of auditor independence. The table, however, shows that age

significantly affected professional investors' perceptions of long audit tenure and audit committees. The results also reveal that, for the variables that were significantly affected by age, the groups with the highest mean ranks were mainly those who were 51-60 years old. These results suggest that older respondents are the more critical in their perceptions of the threat of lengthy audit tenure on auditor independence. It can also be said that older respondents are more confident in the existence of an audit committee as a safeguard to auditor independence.

The combined dataset shows results that are similar to the results of the professional investors. It seems that, when the data from the loan officers and professional investors are combined, the perceptions of long audit tenure and audit committees are affected by respondents' age. Nevertheless, the general findings of the test indicate that older respondents appear to be the most concerned about auditor independence when there is lengthy audit tenure, a partner's financial dependence, provision of NAS to audit clients and ex-auditor employment.

Based on the above findings, Hypothesis 8 can be rejected but only for the professional investor and combined datasets as the results indicate that there are significant differences in the perceptions of long audit tenure and the existence of an audit committee between respondents of different ages in these datasets. Hypothesis 8, however, could not be rejected for the loan officer dataset because the results indicate that there is no significant difference in their perceptions of auditor independence between respondents of different ages.

#### **6.10.4 Respondents' Gender and Perceptions of Auditor Independence**

The following hypothesis was tested using the Mann-Whitney U tests to identify whether there is a statistically significant difference in the perceptions of auditor independence between male and female respondents:

*H<sub>9</sub>: There is no significant difference in the perceptions of auditor independence between male and female respondents.*

<b>Table 6.33: Analysis of Differences in Perceptions of Auditor Independence (AI) between Gender</b>						
	<b>Loan Officers (n = 110)</b>		<b>Professional Investors (n = 67)</b>		<b>Combined (n = 177)</b>	
	<b>Mann-Whitney</b>	<b>Sig.</b>	<b>Mann-Whitney</b>	<b>Sig.</b>	<b>Mann-Whitney</b>	<b>Sig.</b>
A lengthy relationship between an auditor and a client company is a threat to AI.	1463	0.773	521	0.877	3731	0.683
A lengthy relationship with an audit client affects my confidence in an auditor's independence.	1385	0.428	522	0.883	3651	0.511
Even though an audit firm is economically dependent upon its audit client, it could still maintain its independence from that client.	1340	0.274	503	0.688	3565	0.353
When an audit partner's income is dependent on total fees generated from a single audit client, his/her ability to remain independent would be affected.	1466	0.768	528	0.939	3766	0.752
My lending/ investment decisions for a company would be affected if I perceive its auditors to be economically dependent upon it.	1408	0.521	494	0.591	3544	0.317
When an auditor provides non-audit services to an existing audit client, my confidence in the auditor's ability to remain independent would be affected.	1365	0.355	523	0.887	3719	0.650
I am concerned about the independence of a senior auditor who seeks employment with his/her current audit client.	1207	0.051	486	0.526	3244	0.051
If a company hires a senior employee from its audit firm, my lending/ investment decisions for the company will be affected.	1268	0.126	455	0.263	3260	0.057
An audit committee's existence may safeguard AI.	1448	0.710	373	0.038 <sup>a</sup>	3276	0.080

\* Significant at the 5% level.

<sup>a</sup> mean rank: Male - 37.91, Female - 27.83

The results in Table 6.33 show that loan officers' perceptions of auditor independence were not affected by gender. On the other hand, professional investors' perceptions of an

audit committee's existence as safeguards to auditor independence seem to be affected by gender. The results also indicate that the mean rank of male respondents (37.91) is higher than the mean rank of female respondents (27.83). This finding may suggest that the male investors place more confidence than do the female investors in the existence of an audit committee to safeguard independence. Thus, the earlier assumption that male respondents would be less appreciative in the actions to safeguard independence is not supported.

The results of the combined data show that, in general, gender did not have any significant impact on respondents' perceptions of auditor independence. This finding fails to provide support for the assumptions highlighted in Chapter 2 that female respondents will be more concerned about auditor independence impairment due to their caring personality, while male respondents may be less worried since they are more concerned about monetary evidence of independence impairment. Based on these findings, Hypothesis 9 is rejected, but only for the professional investor dataset. Hypothesis 9, however, could not be rejected for the loan officer and combined datasets as the results show that there is no significant difference in the perceptions of auditor independence between male and female respondents.

#### **6.10.5 Comparison of Loan Officers' and Professional Investors' Perceptions of Auditor Independence**

The focus of the current research is on the two financial statement user groups' perceptions of auditor independence. This study recognises that there are differences in the loan officers' and professional investors' objectives of using audited financial statements in making business decisions. Even though in general both groups of respondents agreed that factors such as long audit tenure, financial dependence, NAS and ex-auditors employment with audit clients have negative effects on auditor independence, the results of the descriptive analyses suggest that there are some differences in the loan officers' and professional investors' perceptions of auditor independence. The Mann-Whitney U tests were conducted in order to determine whether there is a statistically significant difference in the perceptions of auditor independence between the two groups. The following

hypothesis was tested in order to identify whether there is a statistically significant difference in the perceptions of auditor independence between the loan officers and professional investors:

*H<sub>10</sub>: There is no significant difference between loan officers and professional investors in their perceptions of auditor independence.*

<b>Table 6.34: Analysis of Differences in Perceptions of Auditor Independence (AI) between Loan Officers and Professional Investors</b>				
	<b>Mann-Whitney U Tests</b>			
	<b>Mean Rank</b>		<b>Mann-Whitney</b>	<b>Sig.</b>
	<b>Loan Officer</b>	<b>Prof. Investors</b>		
A lengthy relationship between an auditor and a client company is a threat to AI.	83.43	98.15	3072	0.049*
A lengthy relationship with an audit client affects my confidence in an auditor's independence.	81.83	100.77	2896	0.012*
Even though an audit firm is economically dependent upon its audit client, it could still maintain its independence from that client.	93.60	81.44	3178	0.103
When an audit partner's income is dependent on total fees generated from a single audit client, his/her ability to remain independent would be affected.	84.30	96.72	3168	0.077
My lending/ investment decisions for a company would be affected if I perceive its auditors to be economically dependent upon it.	83.42	98.16	3071	0.047*
When an auditor provides non-audit services to an existing audit client, my confidence in the auditor's ability to remain independent would be affected.	83.52	98.00	3082	0.048*
I am concerned about the independence of a senior auditor who seeks employment with his/her current audit client.	88.70	89.49	3652	0.916
If a company hires a senior employee from its audit firm, my lending/ investment decisions for the company will be affected.	90.15	87.11	3558	0.681
An audit committee's existence may safeguard AI.	89.24	88.61	3558	0.936

\* Significant at the 5% level.

The results in Table 6.34 reveal significant differences in the perceptions of long audit tenure, economic dependence and NAS between the loan officers and professional investors. The results also show that the professional investor group has higher mean ranks (for the four statements that relate to the three factors affected above) than do the loan officers, indicating that professional investors are more concerned about the effect of long tenure, financial dependence and NAS upon auditor independence than are the loan officers. These results support the earlier assumption that professional investors may be more concerned about issues relating to auditor independence than are loan officers since they provide investment advice to institutional and private investors, thus their reputation and credibility might be affected as well as that of those who rely on their investment recommendations. In addition, even though the general perceptions of economic dependence (by an audit firm or an audit partner) upon an audit client were not affected by the type of respondents, the knowledge that auditors are financially dependent on a single client seems critical as it would affect the respondents' investing decisions. This result further indicates that professional investors seem more worried about the threat of financial dependence and that their investment decisions would be affected if they perceived the auditors to be economically dependent upon the client company. Based on the above discussion, Hypothesis 10 is rejected because there are differences between loan officers and professional investors in their perceptions of auditor independence.

In the next section, discussions on the development of composite scores and the use of the Cronbach alpha coefficient to measure the reliability of a scale will be presented.

### **6.11 Composite Scores**

As mentioned in the previous chapter, a composite dependent variable or a composite score could be developed to reflect an individual's overall perceptions of factors affecting auditor independence. A composite score is created by combining the questionnaire items or statements that make up a scale for each factor. The composite score creates an interval data scale, that is more informative and powerful than an ordinal scale which allows the use of parametric techniques. However, before further tests can be conducted it is



important to ensure that the items that make up the scales are internally reliable. The Cronbach alpha coefficient was used as an indicator of internal consistency for each scale. As a rule of thumb, the alpha coefficient calculated should be above 0.7.

Table 6.35 shows descriptive results of the composite scores and the Cronbach alpha coefficient for each factor affecting perceptions of auditor independence for the loan officer, professional investor and overall datasets.

<b>Table 6.35: Composite Scores – Descriptive Statistics and the Cronbach Alpha Coefficients (before removing any items from the scales)</b>						
	<b>No. of Items</b>	<b>Minimum</b>	<b>Maximum</b>	<b>Mean</b>	<b>Standard Deviation</b>	<b>Cronbach Alpha Coefficient</b>
<b>Loan Officers (n = 110)</b>						
Long audit tenure	3	1.00	5.00	3.24	0.773	0.768
Financial dependence	5	2.00	4.60	3.43	0.493	0.572*
NAS	6	2.00	4.33	3.18	0.417	0.463*
Ex-auditor employment	5	1.00	5.00	3.46	0.686	0.867
Audit committee	7	1.00	5.00	3.86	0.469	0.854
<b>Professional Investors (n = 67)</b>						
Long audit tenure	3	1.67	5.00	3.41	0.84	0.844
Financial dependence	5	2.00	4.80	3.59	0.58	0.700
NAS	6	2.50	4.17	3.20	0.38	0.474*
Ex-auditor employment	5	1.60	5.00	3.40	0.67	0.847
Audit committee	7	3.00	5.00	3.87	0.63	0.926
<b>Overall (n = 177)</b>						
Long audit tenure	3	1.00	5.00	3.31	0.799	0.789
Financial dependence	5	2.00	4.80	3.49	0.533	0.636*
NAS	6	2.00	4.33	3.19	0.402	0.457*
Ex-auditor employment	5	1.00	5.00	3.44	0.680	0.857
Audit committee	7	1.00	5.00	3.86	0.536	0.892

\* Indicate Cronbach Alpha coefficients that are less than 0.7.

The results in Table 6.35 show that the mean average scores of all factors affecting auditor independence for the professional investors are slightly higher than those for the loan officers. This could mean that, on average, the professional investors are more concerned about the impact of long audit tenure, financial dependence, NAS and ex-auditor employment on auditor independence than are the loan officers. However, the differences

between the two groups seem to be small and will be further investigated using parametric t-tests in the next sub-section. As for the audit committee, the mean scores for both groups of respondents are almost equal which could mean that they are equally confident in the existence of an audit committee as a safeguard.

Table 6.35 also reveals that the Cronbach alpha coefficients, before removing any statement(s) for financial dependence and NAS scales, are less 0.7 for the loan officer and overall datasets. The alpha reliability for NAS is also less than the rule of thumb for the professional investor sample. In order to improve the reliability coefficients, Pallant (2001) recommended that items with low item-total correlations (not shown on the table) to be removed from the scale. A low item-total correlation value (less than 0.3) indicates that the item is measuring something different from that of the scale as a whole.

Table 6.36 shows the updated descriptive statistics and the Cronbach alpha coefficients after removing items with low item-total correlation values.

**Table 6.36: Composite Scores – Descriptive Statistics and the Cronbach Alpha Coefficients (after some items were removed from the scales)**

	No. of Items	Min.	Max.	Mean	SD	Cronbach Alpha Coefficient
<b>Loan Officers (n = 110)</b>						
Long audit tenure	3	1.00	5.00	3.24	0.77	0.768
Financial dependence	3	2.00	4.67	3.47 <sup>@</sup>	0.57	0.592 <sup>*#</sup>
NAS	4	1.50	5.00	3.28 <sup>@</sup>	0.59	0.739 <sup>#</sup>
Ex-auditor employment	5	1.00	5.00	3.46	0.69	0.867
Audit committee	7	1.00	5.00	3.86	0.47	0.854
<b>Professional Investors (n = 67)</b>						
Long audit tenure	3	1.67	5.00	3.41	0.84	0.844
Financial dependence	4	2.00	5.00	3.72 <sup>@</sup>	0.75	0.816 <sup>#</sup>
NAS	4	2.25	4.75	3.37 <sup>@</sup>	0.56	0.756 <sup>#</sup>
Ex-auditor employment	5	1.60	5.00	3.40	0.67	0.847
Audit committee	7	3.00	5.00	3.87	0.63	0.926
<b>Overall (n = 177)</b>						
Long audit tenure	3	1.00	5.00	3.31	0.799	0.789
Financial dependence	4	2.00	5.00	3.57 <sup>@</sup>	0.653	0.718 <sup>#</sup>
NAS	4	1.50	5.00	3.31 <sup>@</sup>	0.581	0.744 <sup>#</sup>
Ex-auditor employment	5	1.00	5.00	3.44	0.680	0.857
Audit committee	7	1.00	5.00	3.86	0.536	0.892

\* Indicate a Cronbach Alpha coefficient that is less than 0.7.

@ Indicate increased mean scores after removing items with low item-total correlations from the scales.

# Indicate increased Cronbach Alpha coefficients after removing items with low item-total correlations from the scales.

The results in Table 6.36 indicate that the mean scores for financial dependence and NAS for the three samples increases slightly after items with low item-total correlations were removed. Moreover, the internal reliability of the scales for financial dependence and NAS for the professional investor and overall datasets increase above 0.7 after removing items with low item-total correlations. As for the loan officer sample, only the Cronbach alpha coefficient for NAS increases. The alpha value for the financial dependence scale for the loan officer sample remains below 0.7 even though two items with low item-total correlations were removed.

### 6.11.1 Correlations between Composite Scores

In this sub-section, the correlations between composite scores for the loan officer, professional investor and overall datasets are examined to determine whether there is any correlation between the factors affecting perceptions of auditor independence. It is expected that there will be positive correlations between the threat factors (i.e. if the respondents are worried about a threat factor, they are likely to worry that the other threat factors will also impair auditor independence). Since the variables were computed into an interval form, it is possible to use a parametric test, a Pearson Product-Moment Correlation.

The results of the correlation test for the loan officer sample are presented in Table 6.37.

<b>Table 6.37: Loan Officers - Correlations between Composite Scores</b>				
<b>Pearson Correlation (Sig. 2-tailed)</b>	<b>Financial dependence</b>	<b>NAS</b>	<b>Ex-auditor employment</b>	<b>Audit committee</b>
<b>Long audit tenure</b>	0.434* (0.000)	0.325* (0.001)	0.457* (0.000)	0.393* (0.000)
<b>Financial dependence</b>		0.367* (0.000)	0.355* (0.000)	0.400* (0.000)
<b>NAS</b>			0.344* (0.000)	0.352* (0.000)
<b>Ex-auditor employment</b>				0.302* (0.001)

\* Correlation is significant at the 1% level.

The results of the test suggest that the correlations between the composite scores are significant and positive for the loan officers. The correlations range between 0.302 and 0.457, which Pallant (2001) considered as medium strength relationships. The highest correlation is between the long audit tenure variable and the ex-auditor employment variable which has a correlation of 0.457 and thus a shared variance of 21% (by squaring the correlation value). This means that 21% of the variance in the composite score for the long audit tenure can be explained by the ex-auditor employment. The positive results of the Pearson correlation in Table 6.37 also indicate that respondents have been consistent in their responses. The results suggest that if the respondents are concerned about one of the independence impairing factors (i.e. financial dependence), they are also likely to be

worried about the other independence-impairing factors and vice versa. The positive correlations between the score for audit committees and other factors may indicate that when the loan officers are concerned about the independence-threatening factors, they are likely to be appreciative of the existence of an audit committee.

The results of the correlation test for the professional investor dataset are shown in Table 6.38.

<b>Table 6.38: Professional Investors - Correlations between Composite Scores</b>				
<b>Pearson Correlation (Sig. 2-tailed)</b>	<b>Financial dependence</b>	<b>NAS</b>	<b>Ex-auditor employment</b>	<b>Audit committee</b>
<b>Long audit tenure</b>	0.656* (0.000)	0.677* (0.000)	0.536* (0.000)	0.659* (0.000)
<b>Financial dependence</b>		0.530* (0.000)	0.359* (0.000)	0.578* (0.000)
<b>NAS</b>			0.466* (0.000)	0.468* (0.000)
<b>Ex-auditor employment</b>				0.422* (0.000)

\* Correlation is significant at the 1% level.

Table 6.38 reveals that the correlations between the composite scores for the professional investors are positive and significant. However, unlike the loan officers' results, the correlations are higher and range between 0.359 and 0.677. The strengths of the correlations are medium to large (Pallant 2001). The highest correlation (0.677) is between the composite scores for long audit tenure and NAS. The shared variance between the two variables is 46%.

The results of the Pearson Product-Moment Correlation test for the overall dataset are presented in Table 6.39.

<b>Table 6.39: Overall Dataset - Correlations between Composite Scores</b>				
<b>Pearson Correlation (Sig. 2-tailed)</b>	<b>Financial dependence</b>	<b>NAS</b>	<b>Ex-auditor employment</b>	<b>Audit committee</b>
<b>Long audit tenure</b>	0.541* (0.000)	0.463* (0.000)	0.480* (0.000)	0.512* (0.000)
<b>Financial dependence</b>		0.437* (0.000)	0.339* (0.000)	0.485* (0.000)
<b>NAS</b>			0.383* (0.000)	0.395* (0.000)
<b>Ex-auditor employment</b>				0.351* (0.000)

\* Correlation is significant at the 1% level.

Consistent with the loan officers' and professional investors' results, the correlations between the composite scores for the overall sample are positive and significant. The strengths of the correlations are between medium and strong (0.339 and 0.541). The highest correlation (0.541) is between the composite scores for the long audit tenure and the financial dependence, which share 29% of their variance.

## 6.12 T-Tests

In this study, independent-samples t-tests were used in order to determine if respondents' background variables have an impact on their perceptions of auditor independence. Instead of comparing medians, as in the case of the previous non-parametric Mann-Whitney U tests, independent-samples t-tests compare the mean composite scores for two independent groups such as those with and without accounting qualifications, those with and without prior experience as accountants or auditors in industry, male and female respondents and whether the respondent is a loan officer or professional investor.

The results of the t-tests for the loan officers and professional investors are presented in Table 6.40.

**Table 6.40: Analysis of the Impact of Respondents' Background on Perceptions of Auditor Independence Using T-tests**

	Accounting qualifications	Prior experience (as accountants/ auditors)	Gender
	t-value (Sig.)	t-value (Sig.)	t-value (Sig.)
<b>Loan Officers (n = 110)</b>			
Long audit tenure	1.263 (0.209)	-0.144 (0.886)	0.890 (0.375)
Financial dependence	1.325 (0.188)	2.647 (0.010)*	-0.028 (0.977)
NAS	-1.350 (0.180)	-1.507 (0.135)	0.341 (0.734)
Ex-auditor employment	0.068 (0.946)	-1.214 (0.228)	1.867 (0.065)
Audit committee	0.698 (0.487)	0.234 (0.815)	-0.207 (0.836)
<b>Professional Investors (n = 67)</b>			
Long audit tenure	1.122 (0.266)	1.077 (0.286)	-0.018 (0.986)
Financial dependence	1.191 (0.238)	1.098 (0.276)	-0.013 (0.990)
NAS	1.251 (0.215)	0.555 (0.581)	0.046 (0.963)
Ex-auditor employment	-1.999 (0.050)*	-1.793 (0.078)	1.206 (0.232)
Audit committee	-0.852 (0.397)	0.710 (0.480)	2.057 (0.044)*
<b>Overall (n = 177)</b>			
Long audit tenure	1.534 (0.127)	0.628 (0.531)	0.782 (0.436)
Financial dependence	1.484 (0.140)	2.150 (0.033)*	0.170 (0.865)
NAS	-0.507 (0.613)	-0.828 (0.409)	0.387 (0.700)
Ex-auditor employment	-1.022 (0.308)	-2.081 (0.039)*	2.097 (0.037)*
Audit committee	-0.105 (0.916)	0.690 (0.491)	1.298 (0.196)

\* Significant at the 5% level.

The results in Table 6.40 show that the loan officers' perceptions of factors affecting auditor independence seem unaffected by accounting qualifications. These results are consistent with those of the non-parametric tests, except for the impact of accounting qualifications on perceptions of long audit tenure. Since the t-tests examined the overall perceptions, while the Mann-Whitney U tests previously examined a single statement, the inconsistent findings may be noted.

The results of t-tests for the professional investors also indicate that, except for the ex-auditor employment, accounting qualifications have no influence on most of the factors affecting auditor independence. A statistically significant finding between accounting qualifications and the professional investors' perceptions of ex-auditor employment complements the earlier findings as the non-parametric Mann-Whitney U test failed to uncover this relationship. This finding provides further support for the earlier decision to reject Hypothesis 6.

In order to determine the degree to which the two variables (accounting qualifications and professional investors' perceptions of ex-auditor employment) are significantly associated with one another, Pallant (2001) suggested that the effect of size should be calculated. According to Pallant (2001), "with large samples, even very small differences between groups can become statistically significant" (p. 175). This means that results that are significant may not have any practical or theoretical significance. Therefore, one way of assessing the importance of significant findings is to calculate the "effect size" or "strength of association" (Pallant 2001, p.175). The most commonly used statistics to compute effect size is Eta-squared. Eta-squared can range from 0 to 1 and represents the proportions of variance in the dependent variable that is explained by the independent variable. The formula for eta squared is as follows:

$$\text{Eta-squared} = \frac{t^2}{t^2 + (N1 + N2 - 2)}$$

Using the above formula, the Eta-squared test shows that the effect of accounting qualifications on the professional investors' perceptions of ex-auditor employment was moderate, around 0.06 or 6%<sup>22</sup>.

The results in Table 6.40 further reveal that prior experience as auditors or accountants in industry affects perceptions of auditors' financial dependence on a single audit client for both the loan officer and overall datasets. These results confirm the earlier findings and

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<sup>22</sup> The guidelines for interpreting Eta-squared value are: 0.01 = small effect, 0.06 = moderate effect and 0.14 = large effect (Pallant 2001).



support the decision to reject Hypothesis 7 for both datasets. In addition, the result of the t-test also shows a significant finding between prior experience and perceptions of ex-auditor employment for the combined sample, which was not found using the Mann-Whitney U test. The Eta-squared test shows that the effects of respondents' prior experience as auditors or accountants on perceptions of financial dependence for the loan officer and combined datasets are medium and small, around 6% and 3% respectively. The Eta-squared for the effect of respondents' prior experience on perceptions of ex-auditor employment is also small, that is around 2%.

The results of the t-tests for the professional investors are consistent with those of the non-parametric tests since no significant differences were detected in their perceptions of factors affecting auditor independence between those with and without prior experience.

Further analysis using the t-tests also reveals that there is no significant relationship between gender and the loan officers' perceptions of factors affecting auditor independence, which is in line with the earlier results from the Mann-Whitney U tests. The results of the professional investors are also consistent with the results of the non-parametric tests as no significant difference is found in the perceptions of long audit tenure, financial dependence, NAS and ex-auditor employment between genders. However, the result for audit committees is statistically significant and therefore supports the earlier decision to reject Hypothesis 9 for the professional investor dataset. As for the combined dataset, the results indicate that there is a significant relationship between gender and perceptions of ex-auditor employment. The Mann-Whitney U test failed to uncover this relationship. Further examination using the Eta-squared test indicates that about 6% of the variance in the perceptions of an audit committee (for the professional investor sample) and about 2% of the variance in the perceptions of ex-auditor employment (for the combined sample) can be explained by gender.

The t-tests are also used to examine if there is a significant difference between the loan officers' and professional investors' perceptions of auditor independence. The results of the t-tests are tabulated in Table 6.41.

<b>Table 6.41: Analysis of the Impact of Type of Respondents on Perceptions of Auditor Independence Using T-tests</b>		
	<b>T-tests (n = 177)</b>	
	<b>t</b>	<b>Sig.</b>
Long audit tenure	-1.340	0.182
Financial dependence	-2.286	0.024*
NAS	-1.049	0.296
Ex-auditor employment	0.579	0.563
Audit committee	-0.056	0.956

\*Significant at the 5% level.

The results in Table 6.41 show that there is a significant difference in the perceptions of financial dependence between the loan officers and professional investors. This finding confirms the earlier non-parametric finding and supports the rejection of Hypothesis 10. The Eta-squared test indicates that the effect of the type of respondents on perceptions of financial dependence is small, around 3%. The t-tests fail to detect significant differences in the perceptions of long audit tenure and NAS between the two types of respondents, but were reported as significant by the Mann-Whitney U tests.

In summary, the results of the t-tests provide more confidence in the earlier findings since most of them were consistent with the results of the non-parametric Mann-Whitney U tests. The t-tests also managed to uncover relationships that were not detected in the earlier tests. These complement the prior findings.

### **6.13 Analysis of variance (ANOVA)**

ANOVA is used in this study to determine if respondents' age has an impact on their perceptions of auditor independence. Since there are four groups of ages, a one-way between groups ANOVA compares the variance between these different groups. The results of the tests are presented in Table 6.42.

<b>Table 6.42: Analysis of the Impact of Age on Respondents' Perceptions of Auditor Independence Using ANOVA</b>		
	<b>One-way between groups ANOVA</b>	
	<b>F</b>	<b>Sig.</b>
<b>Loan Officers (n = 110)</b>		
Long audit tenure	1.155	0.331
Financial dependence	0.466	0.707
NAS	0.324	0.808
Ex-auditor employment	0.089	0.966
Audit committee	0.365	0.778
<b>Professional Investors (n = 67)</b>		
Long audit tenure	5.362	0.002*
Financial dependence	2.489	0.068
NAS	1.014	0.392
Ex-auditor employment	0.856	0.469
Audit committee	6.572	0.001*
<b>Overall (n = 177)</b>		
Long audit tenure	4.562	0.005*
Financial dependence	1.787	0.151
NAS	1.002	0.393
Ex-auditor employment	0.672	0.570
Audit committee	4.835	0.003*

\*Significant at the 5% level.

The results in Table 6.42 show that age has no significant impact on loan officers' perceptions of auditor independence. Conversely, the results of ANOVA for the professional investor and overall datasets indicate that age affects respondents' perceptions of long audit tenure and audit committees. These findings confirm the earlier results based on the non-parametric approach using the Kruskal-Wallis tests and support the decision to reject Hypothesis 8 for the professional investor and overall datasets. The effect size for the results can be computed using the following formula (Pallant 2001):

$$\text{Eta-squared} = \frac{\text{Sum of squares between-groups}}{\text{Total sum of squares}}$$

Based on the above formula, the Eta-squared values are 20% and 24%, which means that age has a large impact on the professional investors' perceptions of long audit tenure and the existence of an audit committee respectively. However, the Eta-squared values for the impact of age on perceptions of long audit tenure and audit committee for the combined dataset are moderate, around 7% and 8% respectively.

In order to determine which of the age groups differ, post-hoc tests were conducted using the Tukey HSD test. The significant results of the post-hoc tests are presented in Table 6.43.

<b>Table 6.43: Analysis of Differences in Perceptions between Professional Investors' Age Groups using the Tukey HSD Test</b>				
	<b>Age (I)</b>	<b>Age (II)</b>	<b>Mean Difference (I-II)</b>	<b>Sig.</b>
<b>Prof. Investors</b>				
Long audit tenure	51 - 60 years	30 years or less	1.293	0.005*
		41 - 50 years	1.133	0.028*
Audit Committee	30 years or less	31 - 40 years	-0.515	0.017*
		41 - 50 years	-0.637	0.004*
		51 - 60 years	-0.828	0.019*
<b>Overall</b>				
Long audit tenure	30 years or less	31 - 40 years	-0.375	0.032*
		51 - 60 years	-0.879	0.015*
Audit committee	30 years or less	31 - 40 years	-0.247	0.036*
		41 - 50 years	-0.325	0.012*

\* Significant at the 5% level.

The post-hoc comparisons using the Tukey tests for the age groups indicate that for the professional investors, the perceptions of long audit tenure for age group 51- 60 years are

significantly different from those of age group 30 years or less and 41 - 50 years. These results confirm the earlier results of the non-parametric tests since the mean composite score differences indicate that older respondents seemed more concerned about the impact long audit tenure may have on auditor independence than did their younger counterparts. Similarly, the results for the overall sample suggest that the younger respondents were less worried about the impact of long audit tenure on auditor independence than were the older respondents. Table 6.43 further shows that perceptions of the existence of an audit committee of those age 30 years or less are significantly different from those of older age groups for both datasets. The mean differences suggest that the younger respondents seemed to have less confidence in the existence of an audit committee in safeguarding auditor independence than did their older counterparts. These findings support the earlier decision to reject Hypothesis 8.

#### **6.14 Multivariate ANOVA (MANOVA)**

In the previous sub-section, a series of ANOVAs were conducted separately for each dependent variable. In this section, MANOVA was conducted in order to test if there is a statistically significant difference between groups (i.e. male/female) on a combination of dependent variables (i.e. perceptions of long audit tenure and financial dependence).

A one-way between-groups MANOVA was performed to investigate whether there was a significant difference in perceptions of auditor independence between those with and without accounting qualifications, those with and without prior experience as auditors or accountants in the industry, between male and female respondents, loan officers and professional investors and between respondents of different ages. The findings from these tests provide further support and confidence in the earlier results, particularly those derived from the non-parametric testing.

The results of MANOVA tests are presented in Table 6.44.

<b>Table 6.44: Analysis of the Impact of Respondents' Background on Perceptions of Auditor Independence using MANOVA</b>				
<b>Independent Variables</b>	<b>Wilks' Lambda Sig.</b>	<b>Test of Between-subjects Effect</b>		<b>Higher/ Highest Mean</b>
		<b>DV</b>	<b>Sig.</b>	
<b>Loan Officers (n = 108)</b>				
Accounting qualifications	0.223	N/A	N/S	N/A
Prior experience as auditor/accountant	0.023*	Financial dependence	0.050*	With prior experience
Gender	0.230	Ex-auditor employment	0.009**	Male
Age	0.547	N/A	N/S	N/A
<b>Professional Investors (n = 67)</b>				
Accounting qualifications	0.004*	Ex-auditor employment	0.050*	Without accounting qualifications
Prior experience as auditor/accountant	0.095	N/A	N/S	N/A
Gender	0.115	Audit committee	0.044*	Male
Age	0.000*	Long audit tenure	0.002**	51-60 years
		Audit committee	0.001**	51-60 years
<b>Overall (n = 175)</b>				
Accounting qualifications	0.061	N/A	N/S	N/A
Prior experience as auditor/ accountant	0.006*	NAS	0.031*	With prior experience
		Ex-auditor employment	0.026*	Without prior experience
Gender	0.083	Ex-auditor employment	0.009**	Male
Age	0.006*	Long audit tenure	0.004**	51-60 years
		Audit committee	0.000**	51-60 years
Type of respondent	0.053	Financial dependence	0.014*	Prof. investors

N/A – Not Applicable, N/S – Not Significant, \*Significant at the 5% level, \*\*Significant at the 1% level.

The results in Table 6.44 show that there are no significant differences in the perceptions of auditor independence between those with and without accounting qualifications for the loan officers and overall datasets which are consistent with the earlier findings. As the

results of Wilks' Lambda are not significant, no further investigation is warranted. However, the Wilks' Lambda for accounting qualifications for the professional investor sample is significant which means that there is a significant difference in the overall perceptions of auditor independence between the respondents with and without accounting qualifications. Since the Wilks' Lambda is significant, further tests in relation to each of the dependent variables is permitted. Based on the results of the tests of between-subjects effect, a statistically significant difference is found in the perceptions of ex-auditor employment between respondents with and without accounting qualifications. However, as the study is looking at a number of separate analyses, Pallant (2001) suggested that a higher alpha level using a Bonferroni adjustment should be set to reduce the chance of Type I error. It involved dividing the original alpha level of 0.05 by the number of analyses (or dependent variables) that the study intended to do, the new alpha value being 0.01. Tabachnick and Fidell (2007) stated that the Bonferroni test controls the Type I error rate very well, but could potentially result in a more conservative analysis than that of MANOVA. The results of the ex-auditor employment fail to reach statistical significance using the Bonferroni adjusted alpha level of 0.01. Nevertheless, at the 0.05 level of significance, the results of the MANOVA test support the earlier results from the t-tests.

In testing whether respondents' prior experience as auditors or accountants in industry affects their overall perceptions of auditor independence, the Wilks' Lambda for the loan officers and overall samples are statistically significant at the 0.05 level. As the results are significant, further investigation of the individual dependent variable using the test of between-subjects is permitted. For the loan officer sample, a statistically significant difference is found in the perceptions of financial dependence at the 0.05 level of significance. Similarly, for the overall dataset, statistically significant differences are uncovered in the perceptions of NAS and ex-auditor employment at the 0.05 level of significance. These findings confirm and complement the earlier non-parametric results and provide further support to reject Hypothesis 7 for the loan officer and combined datasets. However, these findings are insignificant if they are compared with the Bonferroni adjusted alpha level of 0.01.

The results in Table 6.44 show that gender has no impact on overall perceptions of auditor independence in all the three datasets since the Wilks' Lambda values are not significant.

The results for the effect of age on overall perceptions of auditor independence are also consistent with prior results that it has an impact on perceptions of auditor independence for the professional investor and combined datasets. Further examinations of the results using the test of between-subjects effect for both datasets indicate that respondents' age affected their perceptions of long audit tenure and audit committees. The results of the tests also show that the differences in age groups reach statistical significance using the Bonferroni adjusted alpha level of 0.01. These results provide more confidence in the previous findings and support the earlier decision to reject Hypothesis 8 for the professional investor and overall datasets.

Finally, the MANOVA tests also examined whether there is a difference between loan officers and professional investors in their overall perceptions of auditor independence. The result of Wilks' Lambda as presented under the combined sample is not significant at the 0.05 level which indicates that there is no significant difference in the overall perceptions of auditor independence between the loan officers and professional investors.

In summary, while the previous tests examined the impact of respondents' background variables on factors affecting auditor independence separately, the MANOVA tests allowed the study to examine the impact of respondents' background variables on the overall perceptions of auditor independence. The results of the tests reveal that the overall perceptions of auditor independence are affected by respondents' background variables such as age, accounting qualifications and prior experience as auditors or accountants in the industry. These results offer more support for the earlier findings, particularly those generated using the non-parametric testing which are claimed to be less powerful compared to parametric testing. Nevertheless, the MANOVA tests indicate that the respondents' overall perceptions of auditor independence are not affected by gender, which is inconsistent with prior findings.



## 6.15 Multiple Regression

The previous sections examined the impact of independent variables (i.e. respondents' background variables) on perceptions of auditor independence in isolation. Multiple regression allows the current study to examine the impact of all independent variables on a dependent variable in a single model or analysis and determine the relative contribution of each of the variables that make up the model.

In this study, the five independent variables (accounting qualifications, prior experience as auditors or accountants in the industry, gender, age and type of respondent) were regressed against respondents' perceptions of auditor independence. Since there are five dependent variables in this study (perceptions of long audit tenure, financial dependence, NAS, ex-auditor employment and audit committees), five separate multiple regressions were performed. Results of the standard multiple regression between the background variables and respondents perceptions of auditor independence are presented in Table 6.45.

**Table 6.45: Standard Multiple Regression of Background Variables and Respondents' Perceptions of Auditor Independence (Model: Perceptions = f (Accounting, Prior experience, Gender, Age, Type))**

	Long audit tenure		Financial dependence		NAS		Ex-auditor employment		Audit committee	
	Beta	Sig.	Beta	Sig.	Beta	Sig.	Beta	Sig.	Beta	Sig.
Accounting qualifications	0.123	0.195	0.045	0.634	-0.009	0.923	0.042	0.658	-0.107	0.244
Prior experience as auditor/ accountant	-0.034	0.711	0.136	0.134	-0.064	0.493	-0.179	0.052	0.110	0.217
Gender	0.012	0.882	-0.021	0.791	-0.004	0.963	0.174	0.031*	0.023	0.773
Age	0.216	0.007*	0.187	0.017*	0.149	0.065	0.084	0.288	0.336	0.000*
Type of respondent	-0.091	0.230	-0.185	0.014*	-0.070	0.360	0.062	0.411	0.043	0.554
<b>F-value (Sig.)</b>	2.472 (0.034)*		3.545 (0.004)*		1.131 (0.346)		2.785 (0.019)*		4.815 (0.000)*	
<b>R-square</b>	0.068		0.095		0.032		0.076		0.125	

\*significant at the 0.05 level

Legend:

Accounting qualifications

= 1 if Yes, 0 if No

Prior experience as auditor/ accountant

= 1 if Yes, 0 if No

Gender

= 1 if Male, 0 if Female

Age

= 1 if 30 years or less, 2 if 31 - 40 years, 3 if 41- 50 years, 4 if 51 - 60 years

Type of respondents

= 1 if Loan officers, 0 if Professional investors

The results in Table 6.45 reveal that the overall multiple regression model for long audit tenure is statistically significant ( $F\text{-value} = 2.472$ ,  $p = 0.03$ ). The R-square value indicates how much the variance in the dependent variable is explained by the model. In this case, the model explains only 6.8% of the variance in the perceptions of long audit tenure. In terms of how well each independent variable predicts the dependent variable, the Beta coefficient for age is the largest and significant, which means that age makes the strongest unique contribution to explaining perceptions of long audit tenure. The positive Beta value indicates that the older respondents are more likely to show concern about the impact of a lengthy tenure on auditor independence. However, unlike the earlier bivariate findings, the other independence variables such as accounting qualifications and type of respondent failed to make a significant unique contribution which could be attributed to the variables overlapping with other independent variables in the model.

The overall multiple regression model for financial dependence is also statistically significant ( $F\text{-value} = 3.545$ ,  $p = 0.00$ ). The R-square value is quite low as only 9.5% of the variance in the perceptions of financial dependence can be explained by the model. The earlier results indicated that age did not have a significant impact on respondents' perceptions of financial dependence. However, the Beta coefficient for age in this model shows that it makes a statistically significant contribution to the variance in perceptions of financial dependence. The coefficient for type of respondents is also significant and negative which means that professional investors are more likely to indicate concern about the consequences when auditors are financially dependent on income from a single client. Nevertheless, the beta coefficient for accounting qualifications is not significant in predicting perceptions of financial dependence and therefore fails to support the earlier findings.

The standard multiple regression model for NAS is not statistically significant ( $F\text{-value} = 1.131$ ,  $p = 0.346$ ) as none of the independent variables make a statistically significant contribution in explaining the perceptions of NAS. The R-square value indicates that the model only explains about 3% of the variance in perceptions of NAS. Except for the type of respondent, the current findings confirm the results from the previous non-parametric testing.

Table 6.45 further shows that the standard multiple regression model for ex-auditor employment is significant ( $F\text{-value} = 2.785$ ,  $p = 0.02$ ). Similar to other models, the R-square value is small, as only 7.6% of the variance in the perceptions of ex-auditor employment can be explained by the model. In addition, only the gender variable has a Beta coefficient that is statistically significant which supports the earlier t-test result. The positive value indicates that males are more likely to be concerned about the negative impact when auditors seek employment with their audit clients. The earlier non-parametric testing revealed that none of the independent variables had significant impacts on perceptions of auditor employment.

The overall multiple regression model for the presence of an audit committee is also significant ( $F\text{-value} = 4.815$ ,  $p = 0.00$ ). The R-square value is small, only 12.5% of the variance in perceptions of audit committees can be explained by the audit committee model. The Beta coefficient for age is the highest and statistically significant indicating that older respondents were more likely to perceive that the existence of audit committees would help to safeguard auditor independence. Although the gender variable does not make a significant contribution to the prediction of perceptions of the audit committee in the regression, it was found to have a significant impact on professional investors' perceptions of audit committees using the non-parametric testing.

The results of the above multiple regression analyses support the earlier decision to reject Hypothesis 8 for the combined dataset as age is found to significantly affect respondents' perceptions of long audit tenure, financial dependence and audit committees. The previous decision to reject Hypothesis 9 is also supported, with the tests showing that gender significantly contributes to the prediction of perceptions of ex-auditor employment. The results of the regression analyses also provide support for the decision to reject Hypothesis 10 since the type of respondent affects the perceptions of financial of dependence.

In summary, the regression analyses conducted in this section have enabled the current study to assess the relationships between respondents' background variables and their perceptions of auditor independence in a single analysis. Even though most of the models

are found to be significant, the R-square values for all the models are small. This means that there are other factors that may have significant influences on respondents' perceptions of auditor independence that are not included in the models. Nevertheless, the multiple regressions revealed that age seems to have exerted an impact on most models which further confirms the earlier findings. In addition, the regression tests also revealed some significant results that were not uncovered in the previous tests and thus provide evidence to support the hypothesis testing.

## **6.16 Chapter Summary**

This chapter presents the results of the questionnaire survey that was sent to loan officers and professional investors in Malaysia. The questionnaire survey sought the respondents' perceptions on issues relating to auditor independence, namely: i) long audit tenure, ii) audit firms' financial dependence on a single audit client, iii) the provision of NAS, iv) ex-auditor employment, and v) the existence of an audit committee. 110 loan officers and 67 professional investors responded to the survey questionnaire. The first part of the analysis of the questionnaire included a combination of descriptive statistics and non-parametric tests such as the one-sample WSRT, the Wilcoxon matched-pairs signed rank test, the Friedman test and the Kruskal-Wallis test. The second part of the analysis involved a series of parametric testing on the composite scores after the statements within each factor were combined.

The results of the survey revealed that the majority of the respondents perceived long audit tenure as a threat to auditor independence. The professional investors showed stronger concern than did the loan officers that a lengthy relationship damages auditor independence. The majority of the respondents also indicated support for an audit partner rotation policy specifically a rotation of every 5-7 years, to be imposed by the regulators. Even though the audit partner rotation policy was perceived as a sufficient safeguard, it was also found that the loan officers preferred such stringent measures as mandatory audit firm rotation, to further safeguard auditor independence.

With regards to audit firms' financial dependence on a single audit client, the majority of respondents believed that auditor independence would be compromised in this situation. Similarly, when audit partners' income is dependent on revenues generated from a single client, the respondents perceived that the partners' independence would be at risk. The majority of the respondents also agreed that the current 15% limit on the total income that audit firms may receive from a single client is sufficient to safeguard auditor independence.

In relation to NAS issues, it was found that the respondents were concerned about the negative impacts that NAS might cause to auditor independence. This concern was reflected in their responses that the provision of NAS by audit personnel would threaten independence. When NAS are performed by staff from separate departments, the perceived threat to auditor independence is reduced. Similarly, the perceived risk of independence impairment is reduced if a separate firm (in which auditors have interests) provide NAS and full disclosures are made in the clients' financial statements. Almost half of the respondents disagreed to ban audit firms from providing NAS but favouring instead the provision NAS to non-audit clients only. Regarding the need to prescribe a maximum limit of NAS fees to total fees by regulators, the results revealed that the respondents agreed with such a requirement and preferred that it should be set within a 15-20% limit. In relation to the types on NAS, the results revealed that there were many significant differences in the respondents' perceptions of the different types of NAS. Most of the types of NAS were perceived as a threat to auditor independence, but some types of NAS were perceived as less threatening.

Analysis of responses relating to issues surrounding ex-auditors' employment with audit clients indicated that this practice is damaging perceptions of auditor independence. The results also showed that auditors' prior supervisory position as audit partners and subsequent positions in a client company that involved preparation of company's accounts were potentially contributing to an independence dilemma. In answer to the question whether the 2-year cooling-off period that audit firms must observe before an audit partner joins a client company offers a sufficient safeguard to auditor independence, only the loan officers produced a positive response.

With regard to the audit committee, the majority of loan officers and professional investors believed that the existence of such a committee, characterised as it is by the current rules, would safeguard auditor independence. The results revealed the highest level of agreement among the respondents to the statement that required at least one member of the audit committee to have accounting and financial expertise. Apart from the role of audit committees, it was also found that a greater disclosure on NAS and NAS fees, staff rotation within audit firms, an independent review of a departing audit partner's work by another partner, a peer review process and immediate investigations on suspected auditors regarding non-compliance with audit and ethical standards, would help in safeguarding auditor independence. The results of the survey also showed that the respondents believed that the accounting profession and the AOB should regulate the auditors of public listed companies.

Analysis of survey results using the non-parametric and parametric tests revealed that demographic factors such as accounting qualifications, prior experience as auditors or accountants, age, gender and type of respondent, to some extent, did have significant impacts on respondents' perceptions of auditor independence.

In the next chapter, a discussion of the research findings, policy implications and contributions of the current research will be presented.

## CHAPTER 7 – DISCUSSION AND IMPLICATIONS OF THE RESULTS

### 7.1 Introduction

The focus of this research is on perceptions of factors affecting auditor independence as held within the business environment in Malaysia. The review of the auditor independence literature in Chapter 2 indicated five factors that are still debated as factors that could affect perceptions of auditor independence. These factors: long audit tenure, financial dependence, NAS, ex-auditors employment with audit clients and existence of an audit committee, were then selected for investigation. Loan officers and professional investors were selected to represent the Malaysian commercial environment and their perceptions were obtained using a mail questionnaire survey and the results were reported in Chapter 6.

This chapter includes a summary of the findings as reported in the previous chapter in relation to the research hypotheses. The results are compared to those of prior studies conducted in Malaysia as well as in other countries and presented in Sections 7.2 to 7.12. Finally, implications from the current findings for the current policy with respect to auditor independence are discussed in Section 7.13. Section 7.14 provides a conclusion for this chapter.

### 7.2 Long Audit Tenure

The first hypothesis of the current study is as follows:

*H<sub>1a</sub>: The length of auditor tenure will not affect loan officers' and professional investors' perceptions of auditor independence.*

Hypothesis 1a was rejected, as the results in Chapter 6 showed that the respondents in this study tended to view a lengthy auditor-client relationship as a threat to auditor independence. The respondents also agreed that their confidence in an auditor's independence would be affected if there were a lengthy association between an auditor and a client company. Further results, however, indicated that the majority of the loan officers

and professional investors did not consider the length of the auditor-client relationship in making lending and investing decisions. They may have held this view because the length of the auditor-client relationship is not required to be disclosed in the clients' financial statements, and therefore did not consider this factor in making lending or investing decisions.

The above results lend support to prior Malaysian studies such as Teoh and Lim (1996) and Abu Bakar et al. (2005). However, it should be observed that the comparison of results between the current study and prior studies may not be precise since each study is distinctive, particularly in terms of its research design, type of respondents and the methods of evaluation of respondents' perceptions of auditor independence. For example, the respondents in Teoh and Lim (1996) consisted of certified accountants and accountants from the industry and utilised an experimental research design whereas Abu Bakar et al. (2005) only focused on loan officers' perceptions. Nevertheless, it can be said that concerns over the threats of long audit tenure have not changed since the study by Teoh and Lim (1996). Perhaps, there is an increase in the awareness of the importance of auditor independence among the users of financial statements in Malaysia particularly since the recent financial scandals in the country involving listed companies.

The results of the study are also consistent with the findings of previous empirical studies in Barbados (Alleyne et al. 2006) and Bahrain (Al-Ajmi and Saudagaran 2011). The current results, however, contradict the conclusions of UK studies by Firth (1980, 1981) and Dart (2011). In these studies, long tenure did not appear to affect the majority of respondents' perceptions of auditor independence. This difference may be due to respondents in the UK viewing lengthier auditor-client relationships as more advantageous in ways other than independence. Findings in a US study by Shockley (1981) were also inconsistent with the current findings. As noted in Chapter 2, Shockley's study is dated. The current perceptions of long audit tenure in the US may have changed significantly, particularly after the widespread and financially devastating business scandals involving Enron and WorldCom in 2001. The issuance of SOX 2002 and recent developments in the business environment such as the banking crisis and global economic crisis, make it



possible that public perceptions have changed significantly since the study conducted by Shockley (1981).

### **7.2.1 Audit Partner Rotation vs. Audit Firm Rotation**

Research hypotheses that relate to audit partner rotation and audit firm rotation are as follows:

*H<sub>1b</sub>: Audit partner rotation will not affect loan officers' and professional investors' perceptions of auditor independence.*

*H<sub>1c</sub>: Loan officers and professional investors perceive that the audit partner rotation policy should not be replaced with an audit firm rotation policy.*

Hypothesis 1b was rejected since the respondents tended to believe that an audit partner rotation would enhance auditor independence. However, while the professional investors seemed satisfied with the current policy, the descriptive statistics indicated that the loan officers would also prefer the current policy to be replaced with a policy of audit firm rotation. This may be because, the loan officers believed that the likely benefits of audit firm rotation exceed the likely benefits of audit partner rotation. Therefore, Hypothesis 1c was also rejected but only with respect to the loan officer sample.

In comparison with prior studies, the loan officers' results are consistent with the findings in prior studies in the US. For example, Daniels and Booker (2009) found that loan officers perceived that audit firm rotation should be implemented as they believed that audit partner rotation would not achieve the same intended benefits as mandatory audit firm rotation. The findings in Gates et al. (2007) also suggested that an audit firm rotation policy will better improve audit quality and enhance auditor independence as compared to when audit partner rotation was exercised. Half of the private investors in a UK study by Dart (2011) were proponents of audit firm rotation as a means of a greater protection of investments, thus supporting the current findings.

In contrast, the results for the professional investors lend support to GAO (2003) which found that partner rotation as required by SOX 2002 would be sufficient to overcome the problem of long audit tenure. GAO (2003) concluded that mandatory audit firm rotation may not be the most efficient way to improve auditor independence. The current results are also consistent with the findings reported by Beattie et al. (1999), Alleyne et al. (2006) and Al-Ajmi and Saudagaran (2011). Dart's (2011) finding on institutional investors' perceptions of partner rotation was also in line with the current finding. The results of the current study, however, are inconsistent with Kaplan and Mauldin (2008) who found no statistically significant difference in the perceptions of auditor independence between the two rotation conditions. The differences in the results may be explained on the grounds that Kaplan and Mauldin (2008) utilised an experimental approach that included the two rotation policies and audit committee's strengths as treatment variables. The study also used MBA students, as proxies for non-professional investors, who were not representative of more sophisticated users such as the professional investors used in this study.

### **7.3 Economic Dependence**

The hypotheses that relate to auditors' economic dependence are presented as follows:

*H<sub>2a</sub>: Loan officers' and professional investors' perceptions of auditor independence will not be affected by the dependence of the audit firm on income from a single audit client.*

*H<sub>2b</sub>: Loan officers' and professional investors' perceptions of auditor independence will not be affected by the dependence of an individual audit partner on income from a single audit client.*

Hypothesis 2a was rejected as the results indicated that as auditors' economic dependence on a single client did affect respondents' perceptions of auditor independence. Hypothesis 2b was also rejected since the loan officers and professional investors tended to perceive that the independence of audit partners would be affected if they were dependent on a single audit client. Further results revealed that the majority of the respondents did not

consider the amount of audit fees a company paid to its auditor when making lending or investment decisions. However, they seemed to believe that their decisions to lend to or invest in a company would be affected if they perceived the auditors to be economically dependent upon the client company. These results seemed to suggest that auditors would not be able to remain independent, nor to perform their monitoring duties objectively when in such circumstances. The rationale is that such auditors would face a self-interest or intimidation threat; they may fear losing the client and might thus be driven to fulfil the wishes of the client's management, especially in conflict situations.

The results of the study provide support for other Malaysian studies such as Teoh and Lim (1996) and Abu Bakar et al. (2005) as they also found that large audit fees received from a single audit client affected the perceptions of Malaysian accountants and loan officers respectively. The findings in Firth (1980), Gul (1991), Gul and Tsui (1992) and Dart (2011) were also in line with the current findings. In addition, Beattie et al. (1999), Alleyne et al. (2006) and Al-Ajmi and Saudagaran (2011) found that economic dependence was considered as the most serious factor undermining auditor independence. Importantly, all of these studies indicated that economic dependence at partner level was ranked top, rather than at the firm or office level. Beattie et al. (1999) strongly suggested that the level at which the economic dependence threat is addressed should also include the partner level. The IFAC (2009) specifically addressed only firm level dependence on audit clients that are public listed entities. Nevertheless, the IFAC (2009) recognised the threats that are created when an audit partner is dependent on a large proportion of income from a single audit client. However, the extent to which the partner's dependency is considered as a threat is still not clear.

### **7.3.1 15% Limit on Audit Firms Total Income from a Single Audit Client**

The hypothesis related to safeguards against economic dependence is as follows:

*H<sub>2c</sub>: The 15% limit on audit firms' total income that the firms may receive from any one client is not sufficient to safeguard auditor independence from problems that may arise due to fee dependence.*

Hypothesis 2c was rejected as the respondents tended to perceive the 15% limit on income from a single audit client to be sufficient in safeguarding independence from problems that may arise due to fee dependence. This result supports the current regulations by the IFAC (2009) and MIA By-Laws that mandated the same limit on total income that audit firms may receive from a single audit client. The results, however, provide limited support for a lower limit such as a 10% limit on the total income that audit firms may receive from a listed audit client as imposed by the APB in the UK.

#### **7.4 NAS**

The following research hypothesis is related to the provisions of NAS by auditors to existing audit clients:

*H<sub>3a</sub>: The provision of NAS by audit firms to audit clients will not affect loan officers' and professional investors' perceptions of auditor independence.*

Hypothesis 3a was rejected since the respondents in this study had the tendency to believe that the provision of NAS by audit firms to their audit clients did affect their perceptions of auditor independence. In making decisions whether to lend to or invest in a company, the respondents, however, indicated that they did not consider the amount of non-audit fees the company pays to its auditor. As with the issue of lengthy audit tenure, one reason the respondents may hold this view is the lack of disclosure of NAS in financial statements. Nevertheless, the results seem to suggest that respondents are aware of the potential impact when auditors provide NAS to audit clients. The main concern here is that auditors may be dependent on income that they derive from NAS which may make it difficult for them to remain independent when they perform audits of the clients' financial statements.

The results of the study further lend support to other Malaysian studies such as Gul and Yap (1984), Teoh and Lim (1996) and Abu Bakar et al. (2005). It appears that concerns over the provision of NAS to audit clients among the financial statement users in Malaysia started long before the collapse of Enron in 2001 in the US. The recent financial scandals involving local companies may have caused more concerns among the interested parties that NAS could negatively affect auditor independence. Similarly, the current findings are consistent with the findings in many behavioural studies conducted in the US, UK, Denmark, Germany and Hong Kong, which all that concluded that NAS reduces the trust placed in auditor independence (Shockley 1981; Firth 1980, 1981; Quick and Warming-Rasmussen 2005, 2009; Law 2008; Dart 2011). Gul (1991) also found that New Zealand's bankers perceived auditors providing NAS were more likely to favour the client in resolving an audit conflict than would auditors not providing NAS. The results in Beattie et al. (1999), Alleyne et al. (2006) and Al-Ajmi and Saudagaran (20011) were also in line with the current findings; they found that the provision of NAS to audit clients ranked highly as one of the factors undermining auditor independence (particularly when NAS fees received were more than 100% of the audit fees received from the same audit clients).

#### **7.4.1 Methods of NAS Provisions**

The hypothesis that is related to this issue is as follows:

*H<sub>3b</sub>: There is no significant difference in loan officers' and professional investors' perceptions of auditor independence when NAS are performed by the same audit personnel and when the staff for audit and NAS are separated.*

Hypothesis 3b was rejected as the results indicated that there are significant differences in the loan officers' and professional investors' perceptions of auditor independence when NAS are performed by the same audit personnel and when the staff for audit and NAS are separated. The perceived threat to auditor independence seemed to reduce significantly

when NAS are provided by staff from a different department within the audit firm or by a separate firm in which the auditors have an interest.

It was also highlighted that the percentage of agreement that auditor independence would be threatened when a different firm (in which the auditors have an interest) provided NAS was higher than when staff from a separate department within the same audit firm provided NAS. This finding may suggest that respondents place more confidence in auditor independence when audit and NAS are performed by different staff within the same audit firm, perhaps due to the existence of better knowledge and understanding about the client which can be shared among them and which could assist in speeding up the process and ensuring better quality services. This advantage will not be achieved if audit and NAS are provided by different firms. This point was also highlighted by one of the loan officers:

*It is fine that NAS and audit are performed by the same audit firm. And I think, this will speed up the production of the audit report. But it is better that a person other than the auditor conducts this NAS work.*

Chapter 6 also revealed that the respondents were not in favour of banning audit firms from providing NAS. The suggestion to ban audit firms from providing NAS was maybe too strict for the local accounting profession and was not considered the best solution to safeguarding auditor independence. Instead, the respondents were in favour of NAS provisions to non-audit clients only. These findings are consistent with Canning and Gwilliam (1999) and provide support for Teoh and Lim's (1996) suggestion that there is a need to restrict the provision of NAS to non-audit clients. This result might also indicate the respondents' belief that auditors should concentrate on one type of service to their clients, either auditing or NAS as this would mitigate the risk of conflict of interest (Canning and Gwilliam 1999). The findings in Dart (2011) suggested that a ban should be implemented on audit personnel providing NAS, but not if a separate division of the same firm were to provide those services.

The significance of the role of an audit committee regarding the issue of NAS was also highlighted in Chapter 6; the majority of loan officers and professional investors agreed

that an audit committee's approval should be obtained before any NAS could be provided by a company auditor. This result may suggest that auditor independence maybe enhanced if audit committee is in-charge of approving NAS by the company auditor. In the US, provision of NAS that are not prohibited by the Act can be provided by an existing company auditor 'only if' the service has been pre-approved by the clients' audit committee (SEC 2003). This requirement, however, is yet to be implemented in any Malaysian regulations.

The findings of the current study are consistent with those obtained by Pany and Reckers (1984) and Canning and Gwilliam (1999) which show that the threat to auditor independence decreased significantly when NAS were conducted by a separate division of the CPA firm, rather than by the same personnel that performed the audit. The interview results in Canning and Gwilliam (1999) stressed the importance of such separation as a means of ensuring that the independence of the auditor was not compromised. The results in Lowe et al. (1999), Swanger and Chewning (2001) and Quick and Warming- Rasmussen (2009) were also in line with the current findings; they found that the staff separation for audit and NAS increased independence perceptions.

#### **7.4.2 The Need to Prescribe a Maximum Percentage of NAS Fees to Total Fees**

The hypothesis related to the need to prescribe a maximum percentage of NAS fees to total fees is as follows:

*H<sub>3c</sub>: The maximum percentage of non-audit fees to total fees paid by a particular audit client should not be prescribed by the accounting regulators.*

Hypothesis 3c was rejected since the respondents tended to believe that a maximum percentage of NAS fees to total fees from an audit client should be prescribed by the accounting regulators to safeguard auditor independence. The results suggest that the respondents would be more confident in auditor independence if more safeguards were in place, to guard against the potential problems that may arise due to provision of NAS to

audit clients. Imposing a maximum percentage of NAS fees to total fees would limit the auditors' reliance on income from such services and thus enhances investor confidence. Che Ayoib et al. (2006) highlighted that 21% of the auditors of NAS-purchased companies have proportions of more than 60% of NAS fees to total fees and considered this situation as worrying. The current findings provide further evidence that there is a need for the regulators to prescribe a maximum percentage of NAS fees to total fees as this is perceived by the respondents to safeguard independence.

#### **7.4.3 Respondents' Perceptions of Different Types of NAS**

The hypothesis related to this issue is as follows:

*H<sub>3d</sub>: The type of NAS provided to audit clients has no impact on loan officers' and professional investors' perceptions of auditor independence.*

Hypothesis 3c was rejected; the results of the non-parametric Friedman test indicated that differences existed in the respondents' perceptions of the thirteen types of NAS. The Wilcoxon matched-pairs signed ranked test was also conducted and the results indicated many significant differences in the perceived threats to independence when individual types of NAS were compared.

The majority of loan officers and professional investors in this study perceived that auditor independence would be most threatened when auditors provided management functions on behalf of the clients. Those forms of NAS that involved an auditor providing accounting-related services also seemed to cause concern. They included bookkeeping and other accounting services, internal audit services, financial information systems design and implementation, assets valuation or appraisal services, actuarial services, corporate finance services, investment advice, dispute resolution services and tax services (which involve calculation for preparing accounting entries). The provision of actuarial services to audit clients are prohibited by the SOX 2002 in the US, but are not included in the IFAC (2009) and MIA By-Laws as the type of NAS having the potential to impair independence. The



above results are consistent with prior studies such as by Quick and Warming-Rasmussen (2005, 2009) and Colbert et al. (2008).

It was also found that litigation support services and human resource services were not perceived by the loan officers as a threat to auditor independence. In contrast, tax services which involved tax compliance and planning services were not perceived by the professional investors as significantly threatening auditor independence. The loan officers' perceptions of human resource services were unexpected since such services are considered as problematic and explicitly forbidden by the IFAC (2009), MIA By-Laws and SOX 2002. The recruitment of senior management for an audit client may create self-interest, familiarity and intimidation threats, especially if those recruited are in a position to exert significant influence over the preparations of the client's accounting records. This result is consistent with the findings in Dart (2011), but contradicts the findings in Quick and Warming-Rasmussen (2005, 2009). The professional investors' perceptions of tax services that involved tax compliance and planning services were in line with the IFAC (2009) and MIA By-Laws which stated that the services did not generally create a threat to independence since the advice is clearly supported by tax authority and has a basis in tax law.

## **7.5 Ex-auditors' Employment with Audit Clients**

The following hypothesis corresponds to the issue of ex-auditors' employment with audit clients:

*H<sub>4a</sub>: The practice of ex-auditors seeking employment with their audit clients will not affect loan officers' and professional investors' perceptions of auditor independence.*

Hypothesis 4a was rejected and it was concluded that the practice of auditors seeking employment with their audit clients *does* have an impact on the majority of respondents' perceptions of auditor independence. Further results also revealed that the loan officers

tended to consider the issue of ex-auditors employment before deciding whether they would lend to or invest in a company but not the professional investors. Similarly, only the loan officers tended to believe that their lending decisions would be affected when learning that a client company hired its auditor.

The current findings are consistent with the majority of prior perceptual studies examined, which concluded that the appearance of auditor independence is negatively affected by the auditor-client employment issue (Imhoff 1978; Firth 1981; Koh and Mahathevan 1993). The findings in Iyer and Raghunandan (2002) were also in line with the current findings as they provided some evidence to support the regulators' concern about the risk of independence impairment when accounting firms' alumni seek employment with their clients. The findings in Dart and Chandler (forthcoming), however, contradict the current findings; they found that institutional investors in the UK were less concerned about the threats of audit clients employing ex-auditors. On the other hand, private investors in their study seemed more critical in their perceptions as they expressed greater concerns about the final audit conducted by an auditor before joining an audit client and the independence of the remaining team in future audits.

#### **7.5.1 Auditors' Prior Position in Audit Firms and Subsequent Position at Client's Company**

The hypotheses relating to ex-auditors' prior position at audit firms and subsequent position at client company are as follows:

*H<sub>4b</sub>: There is no significant difference in the respondents' perceptions of auditor independence when the ex-auditor was an audit partner and not an audit partner.*

*H<sub>4c</sub>: There is no significant difference in the respondents' perceptions of auditor independence when the ex-auditor's subsequent position at a client company involves and does not involve preparation of company's accounts.*

Hypothesis 4b was rejected since there was a significant difference in the respondents' perceptions of auditor independence when the ex-auditor was an audit partner and not an audit partner. The results in Chapter 6 indicated that the majority of both sets of respondents believed that auditors' prior position as audit partners would threaten the independence of the remaining audit engagement team when the auditors joined a client company. Despite these findings, it was also highlighted that the respondents tended to agree that an ex-audit senior (non-audit partner) working for an audit client would still threaten the independence. This may indicate that some respondents were still worried that ex-audit seniors' prior positions as non-audit partners (i.e. audit managers or audit seniors) could still influence the independence of the remaining auditors.

Hypothesis 4c was also rejected since there is a significant difference in the respondents' perceptions of auditor independence when the ex-auditor's subsequent position at a client company involves and does not involve preparation of company's accounts.

The above results are consistent with prior studies by Imhoff (1978), Koh and Mahathevan (1993) and Wright and Booker (2005) as these studies also found that a supervisory position held by an ex-auditor prior to joining an audit client was viewed as impairing independence more than was a non-supervisory position held previously. Similarly, the current findings also provide support for Koh and Mahathevan's (1993) conclusion that the current position of an ex-auditor significantly influenced how subsequent audits would be performed with independence being questioned more when the ex-auditor accepts a position as a preparer of, rather than as a non-preparer of financial statements.

### **7.5.2 Sufficiency of a Cooling-off Period of Two Years**

The hypothesis related to the sufficiency of a cooling-off period of two years in safeguarding auditor independence from problems that may arise due to employment with audit clients is as follows:

*H<sub>4d</sub>: A ‘cooling-off’ period of two years that audit firms must observe before audit partners join an audit client is not sufficient to safeguard auditor independence from problems that may arise due to employment with audit clients.*

Hypothesis 4d was rejected for the loan officer sample as the results indicated that only the loan officers tended to agree that the cooling-off period of two years that audit firms must observe before audit partners join an audit client is sufficient to safeguard to auditor independence. As for the professional investor group, Hypothesis 4d was not rejected since they seemed indifferent concerning this issue.

The results in Chapter 6 seemed to suggest that the 2-year cooling-off period could reduce the negative impact on independence from the revolving door practices of former senior auditors accepting significant positions with audit clients. These findings are consistent with the MIA By-Laws’ requirement and provide support for Wright and Booker (2005) who examined the US state boards of accountancy’s perceptions of the need for a cooling-off period for non-public companies under their jurisdiction. Wright and Booker (2005) found that increasing the length of the cooling-off period from a 1-year period to a 2-year period reduced the revolving door as more respondents disagreed that independence would be impaired with this length of cooling-off period. Nevertheless, the SOX 2002 and IFAC (2009) only require a 1-year cooling-off period before publicly held companies may employ their audit firms’ former employees or partners for key positions. The results of the current study did not support a recommendation for a shorter cooling-off period of 1-year as the respondents still have faith in the current regulation.

## **7.6 Audit Committee**

The hypotheses that relate to the existence of audit committees are as follows:

*H<sub>5a</sub>: The existence of audit committees responsible for the appointment and reappointment of external auditors will not affect loan officers’ and professional investors’ perceptions of auditor independence.*

- H<sub>5b</sub>: The existence of audit committees responsible for review and approval of audit fees will not affect loan officers' and professional investors' perceptions of auditor independence.*
- H<sub>5c</sub>: The existence of independent audit committees will not affect loan officers' and professional investors' perceptions of auditor independence.*
- H<sub>5d</sub>: The existence of at least one audit committee member with accounting and financial expertise will not affect loan officers' and professional investors' perceptions of auditor independence.*
- H<sub>5e</sub>: The existence of active audit committees will not affect loan officers' and professional investors' perceptions of auditor independence.*
- H<sub>5f</sub>: The existence of compulsory audit committee reports in the annual reports of a listed company will not affect loan officers' and professional investors' perceptions of auditor independence.*
- H<sub>5g</sub>: Loan officers' and professional investors' perceptions of auditor independence will not be affected when external auditors report to and are monitored by the audit committee.*

All hypotheses related to audit committees (Hypothesis 5a-5g) were rejected; it was found that the respondents tended to believe that all audit committee characteristics examined in this study would safeguard auditor independence. In realising the complexity and ambiguity of the accounting and financial practices of companies, particularly companies listed on stock exchanges, the independence of the auditors is particularly critical. It is important that at least one member of an audit committee has accounting and financial expertise. The results of this study indicate that the respondents seemed aware of the importance of the audit committee to be able to read, analyse and interpret the financial statements so that they would be able to perform their function effectively. As argued by Carcello and Neal (2003), an audit committee will be more likely to understand and support auditors' decisions (i.e. to issue a GC report) and will be more effective in preventing management from dismissing its auditors subsequent to the issuance of the report.

The results of the study are also consistent with the findings in a prior Malaysian study, Sori et al. (2009) who found that the existence of an active audit committee, compulsory audit committee reports, the approval and review of audit fees by an audit committee and independent audit committee would better safeguard auditor independence. The perceptions of loan officers were investigated in Sori et al. (2009) and their data was collected in 2003. The results of the current study demonstrate that there is no change in the loan officers' perceptions of audit committee's influence on auditor independence over time. Other Malaysian studies such as Teoh and Lim (1996) and Abu Bakar et al. (2005) only examined the existence of an audit committee in general and found it to have a positive impact in increasing the level of confidence in auditor independence. The results in Beattie et al. (1999), Alleyne et al. (2006) and Al-Ajmi and Saudagaran (2011) were also consistent with the current findings since they found that the existence of an independent audit committee was ranked highly as a factor that would enhance independence.

## **7.7 Other Safeguards to Auditor Independence**

In this study, other safeguards to auditor independence as highlighted in prior studies were also examined. The results in Chapter 6 revealed that the loan officers and professional investors believed in the benefits of having; (i) greater disclosures on NAS and non-audit fees paid by auditors to their audit clients, (ii) the systematic staff rotation within the audit firm, (iii) an independent review of the departing auditors' work by another audit senior before joining the client, (iv) audit firms' policies for peer reviews on significant audit decisions, and (v) a peer review program by the relevant regulatory authority. The above finding (i) provides support for Gul and Yap (1984) who found that disclosures of non-audit fees would provide a better understanding of the relationship between an auditor-client. The current finding, however, fails to provide support for Beattie et al. (2013) since they found no evidence to support that disclosures of NAS fees with a detailed breakdown would enhance audit quality in the post-SOX 2002 period. Findings (ii) and (iii) are consistent with the findings in Dart and Chandler (forthcoming) and findings (ii) to (iv) supporting suggestions by Beasley et al. (2000) and Johnstone et al. (2001). Respondents'

agreement for (v) reflected their confidence with the current peer review practice implemented by the MIA. It appears that such a practice could encourage auditors to be independent in performing an audit.

Other results showed that only professional investors had the tendency to disagree with the banning of any senior auditor from seeking employment with an audit client. This finding is in line with Dart and Chandler (forthcoming) as they also found that the UK investors were not in favour of such an action. The results in Chapter 6 further indicated that the majority of the respondents had more confidence in auditor independence if regular inspections of the audit documents of listed companies are conducted by the relevant authority and if immediate investigations on auditors are made if they are merely suspected of non-compliance with audit and ethical standards as opposed to investigations conducted only upon complaints by the public or referrals by other authorities to the relevant regulatory body. In addition, a large majority of respondents perceived that imposing disciplinary actions and sanctions on errant auditors could further safeguard auditor independence.

Finally, it appeared that the respondents still have confidence in the accounting profession to regulate the auditors of public listed companies even though at present that responsibility has been handed to the AOB. This finding is consistent with Beattie et al.'s (2013) argument that was highlighted in Chapter 2 that aspects of the changed regime are largely process and compliance driven, with high costs for limited benefits. This is also consistent with Hirshleifer's (2008) psychological bias theory of regulation which suggests that the public is overconfident that a useful regulatory intervention already exists.

## **7.8 Respondents' Accounting Qualifications and Perceptions of Auditor Independence**

Research Hypothesis 6 is related to whether differences in perceptions of auditor independence are due to the respondents' having accounting qualifications:

*H<sub>6</sub>: There is no significant difference in the perceptions of auditor independence between respondents with and respondents without accounting qualification.*

Hypothesis 6 was rejected; the results in Chapter 6 indicated that there are significant differences in the respondents' perceptions of long audit tenure and financial dependence between respondents with and respondents without accounting qualifications. The results also indicated that those with accounting knowledge were more concerned about the threat of long audit tenure and financial dependence on auditor independence than were those without qualifications. Bartlett (1993) explained that increased knowledge in accounting does not automatically result in positive evaluations of auditor independence. In his study, Bartlett, however, concluded that accounting knowledge does not significantly affect respondent's perceptions of independence. The results of this study also contradict the findings in Dart (2011) and Dart and Chandler (forthcoming). Dart (2011) found that private investors without accounting qualifications were more concerned about the threat of long tenure and financial dependence, whereas Dart and Chandler (forthcoming) found that the same respondents were also concerned about threat of client employment of an ex-auditor. Nevertheless, the current findings are consistent with Pany and Reckers (1983, 1984) as it was found that the respondents' perceptions of NAS were not affected by accounting qualifications. As descriptive results highlighted that there is a common concern when auditors provide NAS to their audit client, its impact on perceptions of auditor independence may be severe regardless of whether respondents have accounting qualifications or not.

## **7.9 Respondents' Prior Experience as Auditors or Accountants and Perceptions of Auditor Independence**

The hypothesis that relates to respondents' prior experience as accountants or auditors is as follows:



*H<sub>7</sub>: There is no significant difference in the perceptions of auditor independence between respondents with prior experience and respondents without prior experience in accounting firms or as accountants in the industry.*

Hypothesis 7 was rejected for the loan officer and combined datasets as the results in the previous chapter showed that significant differences in the perceptions of financial dependence between respondents with prior experience and respondents without prior experience in accounting firms or as accountants in industry were only detected in those datasets. These results contradict Firth's (1980) argument as it was found that respondents with prior working experience as accountants or auditors were more concerned about audit firms' financial dependence as compared to those who have no working experience. The current findings also disagree with Dart and Chandler's (forthcoming) results as they reported that those who had prior experience in moving from audit firms to audit clients showed the lowest level of concern about the implication of such a career move in terms of threats to auditor independence. They inferred that there is a possibility that those respondents may be reluctant to admit that the process of moving from an audit firm to an audit client could impair auditor independence.

#### **7.10 Respondents' Age and Perceptions of Auditor Independence**

The hypothesis related to whether the age of the respondents has an impact on their perceptions of auditor independence is as follows:

*H<sub>8</sub>: There is no significant difference in the perceptions of auditor independence between respondents of different ages.*

Hypothesis 8 was rejected but only for the professional investor and combined datasets as the results showed that there were significant differences in the perceptions of long audit tenure and the existence of an audit committee between respondents of different ages in these datasets. The general findings of the tests indicated that older respondents appeared to be more concerned that auditor independence might be affected when there were lengthy

audit tenure, partners' financial dependence, provisions of NAS to audit clients and ex-auditors employment than were younger respondents. These findings support Peterson et al.'s (2001) and Deshpande's (1997) conclusion that respondents tend to become more conservative in their ethical perspectives as they grow older. These findings, however, are inconsistent with Firth (1980) who reported that age did not account for differences in various groups of respondents' perceptions of either auditor independence or official ethical guidelines.

### **7.11 Respondents' Gender and Perceptions of Auditor Independence**

The following hypothesis was tested to determine whether there was a statistically significant difference in the perceptions of auditor independence between male and female respondents:

*H<sub>9</sub>: There is no significant difference in the perceptions of auditor independence between male and female respondents.*

The results in the previous chapter revealed that gender significantly affected professional investors' perceptions of audit committees and perceptions of ex-auditors' employment with audit clients for the combined dataset. On the other hand, the results for the loan officers showed that in general, gender did not have any significant impact on perceptions of auditor independence which is consistent with Dart (2011) and Dart and Chandler (forthcoming). Based on these results, Hypothesis 9 was rejected, but only for the professional investor and combined datasets.

### **7.12 Loan Officers vs. Professional Investors**

Research Hypothesis 10 set out to identify whether there is a statistically significant difference in the perceptions of auditor independence between the loan officers and professional investors:

*H<sub>10</sub>: There is no significant difference between loan officers and professional investors in their perceptions of auditor independence.*

Hypothesis 10 was rejected; the results outlined in Chapter 6 revealed that there were significant differences in the perceptions of auditor independence between the loan officers and professional investors. In general, the professional investors seemed more concerned about long audit tenure, financial dependence and NAS than did the loan officers. These results suggest that the respondents' differing objectives in using audited financial statements could affect their perceptions of auditor independence. As mentioned in the previous chapter, professional investors provide investment advice to institutional and private investors, and thus, in the case of corporate collapse, their own reputation and credibility might be affected as well as that of those who rely on their investment recommendations. On the other hand, loan officers normally deal with corporate loans which usually require lenders to provide guarantees or collateral which could reduce their auditor independence concerns.

### **7.13 Implications and Contributions of the Current Research**

After analysing the data from the questionnaire survey of the loan officers and professional investors, the following policy implications and contributions are noted:

1. The aim of this research is to extend the literature by presenting results on perceptions of auditor independence from the perspective of an emerging market. As perceptions of auditor independence may change over time, this study is relevant as recent evidence is presented since Malaysia has just experienced financial scandals that have not only eroded investor confidence but have also affected the capital market, the regulators and the accounting profession.
2. The study focuses only on perceptions of users of audited financial statements as prior studies have shown that auditors were more confident in their ability to remain independent while users seemed more critical in evaluating the auditors'

ability to remain independent. Since different users have distinct objectives in using financial statements, it is more appropriate to examine their perceptions separately. This study is the only known Malaysian study that has examined in detail the independence perceptions of different users of audited financial statements.

3. This study could benefit the Malaysian auditing regulators, particularly the MIA and the recently established AOB, in updating and revising the current MIA By-Laws. This is because much of the consideration of audit issues and the setting of audit rules has only involved members of the MIA and other professional accounting bodies, auditors, regulators and academicians, leaving the views of those who actually rely on the financial reports often neglected for many reasons. The results of a study which considers the views among the main users of audited financial statements in the country could be of great assistance to the MIA and the AOB in their next revision of the current By-Laws.
4. This study provides evidence that the loan officers and professional investors agreed that the current rotation of audit partners would safeguard auditor independence. However, the loan officers would be more confident in auditor independence if the current rotation policy were replaced with rotation of audit firms. Despite this finding, those surveyed acknowledged that the implementation of mandatory audit firm rotation would add more costs to audit firms and audit clients. Since the Malaysian audit market can be considered small with a limited number of audit firms with expertise specific to each industry, the implementation of audit firm rotation may not be necessary. The results also showed that the respondents preferred audit partners to be rotated every 5-7 years, which is a preference that echoes current practice.
5. This research also found that the current policy whereby audit firms could only receive a maximum of 15% of their total income from a single listed audit client is considered sufficient to safeguard auditors from relying heavily on income from that client. A lower income limit is also found to be unnecessary. In order to ensure

that the current requirement is observed, a rule that requires audit firms to declare their annual income and expenses should be set in place so that proper monitoring mechanisms can be implemented. At present, the Malaysian audit firms are subject to practice review by another qualified member within the accounting profession and this is the only monitoring mechanism working to ensure that the firms operate at least to the minimum requirement of the audit standards. Since audit firms are selected at random for the practice review, the practical implications of monitoring may be difficult, whether the rest of the firms have exceeded the total income requirement from a single audit client or not. Therefore, with regard to the financial dependence issue, the rule that requires audit firms' declaration of their income may be more effective in helping relevant regulators to monitor the firms' practices.

6. The results of the study also show that perceptions of auditor independence would be affected when audit partners depend on income generated from a single audit client. The current policy specifically addresses firm level dependence on audit clients that are public listed entities but the rules for audit partners' income dependency is still not clear. The policy-makers should consider making a more specific rule on audit partners' financial dependence on income from a single client as they are the ones who make audit decisions and their independence would be questioned as the self-interest threat is created when the fees generated from an audit client represent a large proportion of the partners' revenue.
7. The results of the study indicate that audit personnel should be banned from providing NAS to their audit clients. This prohibition should be clearly stated in the ethical rules. However, the provision of NAS to audit clients should be allowed if the services are provided by different personnel either from separate departments or from entities in which the auditors have an interest. In addition, there are several types of NAS that should not be provided to audit clients since they cause specific concern. These include: bookkeeping and other accounting services, internal audit services, FISDI, management services, valuation services, corporate finance

services, dispute resolution services and tax services (those that involve calculations for preparing accounting entries).

8. The policy-makers should enhance the role of an audit committee by giving them the authority to review and approve the type of NAS that auditors are allowed to perform for audit clients. This practice is consistent with the SOX 2002 requirement that only allows auditors to provide NAS (that are not prohibited) if the services have been pre-approved by the clients' audit committee.
9. Even though the limit of 15% of audit firms' total income from a single listed audit client is considered sufficient to safeguard auditors from relying heavily on income from that client, the policy-maker should also consider prescribing a maximum limit of NAS income to total income as the survey indicated that it would further safeguard auditor independence.
10. The results of the study showed that financial statement users are concerned about the practice of ex-auditors seeking employment with audit clients. However, the cooling-off period of two years that audit firms must observe before an audit partner joins a client company was perceived as sufficient to safeguard auditor independence. The 2-year period can be considered too long as the SOX 2002 and IFAC (2009) only require a 1-year cooling-off period. As the majority of respondents seemed to support the current policy, a reduction or an extension of the existing cooling-off period is not necessary. The results also showed that a ban on ex-auditors' seeking employment from their audit clients is not necessary.
11. The results of the study also showed that ex-auditors' prior position as non-audit partners (prior to joining a client company) could also create a threat to auditor independence. Thus, it can be suggested that the cooling-off period to be observed by audit firms prior to auditors joining an audit client should be extended to other senior positions, i.e. Managers in-charge of the audit, and not only focus on audit partners.

12. This study provides evidence that the peer review exercise, regular inspections of audit documents, immediate investigations on suspected errant auditors and impositions of disciplinary actions could further safeguard auditor independence. As auditors of public listed companies are now monitored by the newly established, AOB, these exercises are now under the responsibility of the AOB. There is a need for a concerted effort between the MIA and the AOB to ensure that the peer review exercise is continued and that the investigation process be fast and effective. A special committee for each task (peer review, investigations and disciplinary actions) should serve to appoint highly qualified people with reputations and integrity.
13. The results of the study showed that the respondents still believed that the accounting profession should regulate auditors of public listed companies. Based on this finding, the users of audited financial statement should be well-informed that the AOB is the new regulator of the auditors of public listed companies. The knowledge that auditors are now monitored by a special body which emphasises the importance of the role of auditors and audit quality could hopefully improve investor confidence and promote more informed decision making in lending and investing.

#### **7.14 Chapter Summary**

This chapter discusses the results of the questionnaire survey that were reported in the previous chapter in relation to the research hypotheses. Comparisons of the results with prior studies were also presented in this chapter. The current results on long audit tenure, financial dependence, NAS and audit committees were consistent with the results reported in prior Malaysian studies and most studies conducted in other countries. The results on the issue of ex-auditors' employment with audit clients were also in line with the findings in prior studies, except that of Dart and Chandler (forthcoming). Comparisons of the current results with prior studies on the impact of background variables on respondents'

perceptions of auditor independence, however, showed that the current results were inconsistent with the results of prior studies. The current results revealed that respondents with accounting qualifications and work experience as accountants or auditors were more concerned about the threats to auditor independence than were those without accounting qualifications and working experience.

The respondents' perceptions of financial dependence, NAS and client employment of an ex-auditor seemed to suggest certain policy implications. Similarly, the results on other safeguards to auditor independence such as peer review exercises and the existence of the AOB should be of interest to the relevant authorities, as has been discussed in this chapter.

The following chapter will provide a conclusion and limitations of the study and offering recommendations for future research.



## **CHAPTER 8 – SUMMARY AND CONCLUSIONS**

### **8.1 Summaries of the Thesis**

There are eight chapters in this thesis. Chapter 1 presented the overview of the current research, highlighted the motivation of the study and emphasised the objectives of the study. In Chapter 2, a discussion on the literature on auditor independence was presented. The main issues discussed were the definitions of auditor independence, agency theory which underpins the current study and the five factors having the potential to affect perceptions of auditor independence. Agency theory emphasises the importance of auditor independence in order for audit services to be meaningful within the agency relationship. Within agency theory, auditors are said to have no role to play if they have conflicts of interest with the clients whose financial statements they audit. It is also crucial that financial statement users, such as loan officers and professional investors, perceive that auditors are independent from client management. This is because, if the auditors are perceived as not independent, their opinions on clients' financial statements will be regarded as of no value. This will also result in users' having less confidence in the financial statements and in the proliferation of greater uncertainty in the capital market. The five factors affecting auditor independence, highlighted in Chapter 2 were: long audit tenure, economic dependence on a single audit client, the provision of NAS to audit clients, ex-auditors' employment with audit clients and the existence of an audit committee. The chapter also highlighted some literature on demographic factors that may influence perceptions of auditor independence.

After extensively reviewing the literature in Chapter 2, Chapter 3 outlined the structure of the Malaysian audit market. Since the current study seeks the perceptions of loan officers and professional investors in Malaysia, an understanding the auditing and financial reporting background of the study is essential, as it provides a better understanding about the issues under study. The review of the literature in Chapter 2 and the background information in Chapter 3 help the current study to develop the research questions and hypotheses presented in Chapter 4.

In order to provide answers to the research questions and to test the hypotheses, a postal questionnaire survey method was employed in this study. Details as to the methodology adopted were discussed in Chapter 5. Loan officers and professional investors were chosen as respondents for the survey as they are among the main users of audited financial statements in the country and as their concerns about auditor independence may affect real lending and investing decisions. The chapter also discussed the advantages and disadvantages of using the survey method and the statistical techniques employed to analyse the questionnaire data. The rationale of using non-parametric and parametric tests was also highlighted in this chapter.

Analyses of responses to the questionnaire survey were discussed in Chapter 6. 110 loan officers and 67 professional investors responded to the questionnaire survey after three mailing exercises. The analyses conducted in this chapter provide answers to the research questions as the research hypotheses can be tested. In Chapter 7, a summary of the research findings and comparisons of the findings with prior studies were presented. The policy implications and contributions of the current study were also outlined in this chapter.

## **8.2 Main Findings of the Research**

Based on the data analysis presented in Chapter 6, the results indicated that the loan officers and professional investors perceived long audit tenure, financial dependence on an audit client, the provision of NAS to audit clients and the employment of auditors as threats to auditor independence. These results provided answers to the research questions (Research Questions 1-4) of this study as highlighted in Chapter 4. The results also showed that the greatest threat to auditor independence arises when audit partners' income is dependent on total fees generated from a single client. However, the current regulation regarding partners' income is still unclear as no specific percentage has been prescribed by the regulators to limit the partners' reliance on income from an audit client. On the other hand, the provision of NAS to audit clients was considered to be the least threatening despite the widespread concern that the joint provision of audit and NAS would damage auditor independence perceptions.

The majority of the respondents in this study perceived the existence of an audit committee with its specific characteristics as the main safeguard against the threats to auditor independence. These findings answered Research Question 5 of this study. In addition, the respondents seemed satisfied with most of the current safeguards currently in place. The loan officers, however, in marked contrast to the professional investors, indicated that they were in favour of a system of mandatory audit firm rotation. Despite these revelations, both groups of respondents agreed that replacing the current audit partner policy with mandatory audit firm rotation would be costly to both the auditors and audit clients. The results of the study also revealed that a limit on NAS income as a proportion of a total firms' income from an audit client should be prescribed as this was found to enhance perceptions of auditor independence. Apart from that, although the descriptive analysis showed that most of the professional investors agreed with the implementation of the 2-year cooling-off period, further analysis indicated that they were not inclined to agree with the policy.

Other safeguards such as greater disclosures on NAS and non-audit fees paid by auditors to their audit clients, systematic staff rotation within the audit firm, an independent review of the departing auditors' work by another senior auditor before joining the client, and audit firms' policies for peer reviews on significant audit decisions were also found to enhance auditor independence. In addition, actions by the regulators such as peer review exercises, regular inspections of audit documents and immediate investigations into suspected misbehaviour among auditors were perceived positively by the respondents. These findings provided answers to Research Question 6 of this study.

The results also showed that the loan officers still believed in the accounting profession to regulate auditors of public listed companies without the need for intervention by the AOB, while the professional investors seemed indifferent with regard to this issue. Finally, the respondents in this study appeared to still have confidence in the audited financial statements and used the audit report in making lending and investing decisions. This could mean that they still have a strong belief in the credibility of the accounting profession

despite the recent accounting scandals involving several listed companies that have affected the integrity of the local capital market, the regulators and the profession.

In terms of the impact of background information on respondents' perceptions, this seemed to have more impact on the professional investors than on the loan officers. The professional investors' perceptions of auditor independence seemed to be affected by all the background variables (accounting qualifications, prior experience as auditors or accountants in the industry, gender, age and types of respondents). On the other hand, the loan officers with accounting qualifications and prior experience as accountants or auditors were more concerned about the threat of long audit tenure and financial dependence respectively, than were those without accounting qualifications and prior working experience. The respondents' perceptions of NAS were not affected by their background variables. This result may be due to the common concern that NAS provided to audit clients may impair auditor independence. Based on these findings, Research Question 7 of this study was answered.

### **8.3 Limitations and Recommendations for Future Research**

This study is subject to a number of limitations that need to be acknowledged, which are mainly related to its research design. Firstly, the weaknesses associated with the quantitative survey research used in this study namely; respondent representativeness, respondents' different interpretations of the questions, low response rates and non-response bias, are inevitable to some degree. In terms of the representativeness of the respondents, the use of volunteer bank loan officers may have limited the application of the findings to a particular group of respondents. In respect to the different interpretations of the questions by the respondents, the researcher made reasonable efforts to ensure that wording and sentences were straightforward and precise. Furthermore, pilot testing was conducted prior to the distribution of the survey questionnaires to the sample populations. With regard to a low response rate, it creates a possibility that the respondents' responses may not be representative of the entire population. Although the result of the non-response bias test

was negative, a higher response rate especially among the professional investor group would have provided a deeper insight into professional investors' perceptions.

Secondly, the study only examined the perceptions of two groups of financial statement users; loan officers and professional investors. The findings from the study can be generalised only to these two groups. Future studies could investigate the perceptions of other users such as institutional and private investors, audit committees and members of regulatory bodies. Their views are also important as they have very different motivations for using financial statements. Their expectations of auditor independence should be recognised so that comprehensive rules on auditor independence could be developed that take into considerations the views of all affected parties.

Thirdly, due to constraints of time and cost, the study only focused on the five factors affecting independence perceptions. If more factors were to be included, the questionnaire survey would be too lengthy for the respondents to answer and this would affect the response rate. Future study could examine other factors such as the existence of internal audits, board of directors' composition and the adoption of the Financial Reporting Standards, determining whether these factors could help safeguard or pose a further threat to perceptions of auditor independence.

Fourthly, the use of the questionnaire survey with the 5-point Likert scale may not have adequately measured the respondents' perceptions of auditor independence. It also prevented the current study from probing more deeply into the users' perceptions of auditor independence. More information could have been gathered if the study had included interviews such as that of Canning and Gwilliam (1999). Nevertheless, due to the constraints of time and cost, the use of one method is believed to be sufficient to achieve the research objectives.

The use of the 5-point Likert scale in the questionnaire survey also prevented the current study from the use of more powerful parametric testing to analyse the survey data. As most of the data were in an ordinal form, the study could only rely on the non-parametric techniques to test most of the research hypotheses. The parametric tests could be used to

test only five hypotheses after the respondents' overall perceptions of the five factors affecting auditor independence were developed (by adding and averaging the scores for all the relevant statements in each theme) and the data became interval data. Future studies could focus in this area by developing a more comprehensive scale for each factor and other independence enhancement factors (e.g. mandatory auditor rotation) and use parametric testing as a method of data analysis.

Another limitation of this study was that the scale for financial dependence for the loan officer sample that was used to compute the composite scores had low reliability or internal consistency (0.592). Even after items with low item-total correlation were removed, the scale had an alpha coefficient of less than the minimum required. As a result, the low reliability of the financial dependence scale for the loan officer sample remained a limitation of this study.

The measure of accounting qualifications in this study was based on whether the respondents' academic field of study was in accounting, regardless whether it was a diploma, degree or professional qualification. Since some of the respondents had finished their studies for quite some time, their actual accounting knowledge may not have been up to date. Some respondents may have taken short courses in accounting but this was not considered as having an accounting qualification although it was recent and just as useful. Future studies may use a more complete definition of accounting qualifications so that the impact of this variable on perceptions could be properly examined.

This study only investigated the impact of the 2-year cooling-off period that audit firms must observe before audit partners join a client company and their audit firms could continue serving the audit clients. The 2-year cooling-off period was perceived as a sufficient safeguard of auditor independence. As the study also found that ex-auditors' prior positions as non-audit partners could also lead to independence impairment, future studies could examine the specific types of non-partner positions and whether the 2-year cooling-off period still applies.

As mentioned in Chapter 7, the comparison of results between the current study and prior studies may not be precise and it remains difficult to form clear inferences from such comparisons due to differences in terms of research design, research instrument, type of respondents and the methods of evaluation of respondents' perceptions. Future studies could adopt a two or multi-country study, which controls for time period and research design and thus will provide support for more meaningful comparisons.

Finally, this research focused on auditor independence issues and regulations that mainly affected the practice of the auditors of public listed companies. Independence issues related to non-listed companies, government organisations and societies could be pursued by future research. In addition, future studies could also investigate the relative cost-benefit of various measures that could safeguard auditor independence (i.e. full disclosure of NAS fees, a total ban on ex-auditors' employment with audit clients). This would be highly beneficial since users of financial statements will always ask for more information and more regulations particularly in the aftermath of financial scandals with expectations that audit quality will improve. The current study only examined the respondents' perceptions of cost-benefit impact of the implementation of audit firm rotation, but not other measures that could enhance auditor independence. Last but not least, future studies could also examine other individual factors that may influence perceptions such as attitude towards risk. Respondents' risk attitude (averse or preference) may have an impact on perceptions and judgment of the auditor. Farmer (1993) contended that individual differences in risk tolerance may contribute to the lack of consensus in prior studies on auditors' assessment of internal control system.

#### **8.4 Thesis Conclusion**

This thesis contributes to the existing literature on auditor independence by providing an insight from the perspectives of an emerging market, particularly the Malaysian context. In response to the financial scandals involving local listed companies in 2007-2008, this study was conducted to provide recent evidence and further understanding on the role of auditors and the accounting profession in maintaining the integrity of the financial reporting

process. The perceptions of two main users of audited financial statements in Malaysia were sought in order to determine the current perceptions of factors affecting auditor independence and the sufficiency of safeguards that are in place.

The results of the study indicated that adequate safeguards of auditor independence are in place to protect investors who rely on financial statements as a source of information. Nevertheless, there are mechanisms that the financial statement users believed should be implemented that could provide greater protection for their investment. The findings of this study should be of interest of the MIA and AOB to be considered in their assessment and revision of the country's current independence regulations. Finally, the audit regulation in Malaysia is likely to be more stringent since the establishment of the AOB in 2010. Those relying on the work of auditors should recognise the roles of the AOB which stress the importance of the auditors' functions and audit quality. It is hoped that, enhanced audit quality will increase investor confidence in the accounting profession and promote a culture of more informed lending and investing decision making.



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## **APPENDICES**

**APPENDIX 1 – COVER LETTERS AND SURVEY QUESTIONNAIRES**

**APPENDIX 2 – ETHICAL APPROVAL FORM**

## **APPENDIX 1 – COVER LETTERS AND SURVEY QUESTIONNAIRES**

### Cover letter for the Questionnaire to Professional Investors

Dear Sir/ Madam

#### **Professional Investors' Perceptions of Auditors' Independence**

I am a lecturer at the International Islamic University Malaysia (IIUM) and currently conducting postgraduate research under the supervision of Professor Roy Chandler at Cardiff University, United Kingdom, into issues surrounding auditors' independence.

Auditor independence issues have a huge impact on the accounting profession and our business community in general. Independence is the foundation of the auditing profession. It is the objective of this research to seek the opinions of professional investors in Malaysia such as financial analysts and fund managers on several issues related to auditor independence. Since you are one of the main users of audited financial statements, your opinions are important.

I would be very grateful if you could take 10-15 minutes of your time to complete the attached questionnaire. I assure you that views expressed in the questionnaire will be treated in complete confidence. The code on the front page of the questionnaire will be used only to facilitate statistical analysis and for sending reminders to those who have not responded.

Your participation and cooperation is very much appreciated. Thank you.

Yours faithfully,

MASLINA AHMAD

E-mail: [maslina@iiu.edu.my](mailto:maslina@iiu.edu.my)

Phone: 03-61964662

Cover letter for the Questionnaire to Loan Officers.

Dear Sir/ Madam

**Loan Officers' Perceptions of Auditors' Independence**

I am a lecturer at the International Islamic University Malaysia (IIUM) and currently conducting postgraduate research under the supervision of Professor Roy Chandler at Cardiff University, United Kingdom, into issues surrounding auditors' independence.

Auditor independence issues have huge impact on the accounting profession and our business community in general. Independence is the foundation of the auditing profession. It is the objective of this research to seek the opinions of loan officers in Malaysia on several issues related to auditor independence. Since you are one of the main users of audited financial statements, your opinions are important.

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Your participation and cooperation is very much appreciated. Thank you.

Yours faithfully,

MASLINA AHMAD

E-mail: [maslina@iiu.edu.my](mailto:maslina@iiu.edu.my)

Phone: 03-61964662

1<sup>st</sup> follow-up letter for the Professional Investors

Dear Sir/ Madam

**Professional Investors' Perceptions of Auditors' Independence**

I am a lecturer at the International Islamic University Malaysia (IIUM) and currently conducting postgraduate research under the supervision of Professor Roy Chandler at Cardiff University, United Kingdom, into issues surrounding auditors' independence.

I recently sent you a copy of questionnaire survey regarding professional investors' perceptions of auditor independence in Malaysia. If you have already returned the questionnaire, I would like to thank you for your prompt feedback. However, if you have not had the chance to complete the questionnaire, I would be very grateful if you could do so. In case you have misplaced the questionnaire that I sent previously, a copy of the same questionnaire and post-paid envelope are also attached.

I assure you that views expressed in the questionnaire will be kept completely confidential.

Your cooperation is very much appreciated. Thank you.

Yours faithfully,

MASLINA AHMAD

E-mail: [maslina@iiu.edu.my](mailto:maslina@iiu.edu.my)

Phone: 03-61964662/4698

1<sup>st</sup> follow-up letter for the Loan Officers

Dear Sir/ Madam

**Loan Officers' Perceptions of Auditors' Independence**

I am a lecturer at the International Islamic University Malaysia (IIUM) and currently conducting postgraduate research under the supervision of Professor Roy Chandler at Cardiff University, United Kingdom, into issues surrounding auditors' independence.

I recently sent you a copy of questionnaire survey regarding loan officers' perceptions of auditor independence in Malaysia. If you have already returned the questionnaire, I would like to thank you for your prompt feedback. However, if you have not had the chance to complete the questionnaire, I would be very grateful if you could do so. In case you have misplaced the questionnaire that I sent previously, a copy of the same questionnaire and post-paid envelope are also attached.

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Yours faithfully,

MASLINA AHMAD

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Phone: 03-61964662/4698

2<sup>nd</sup> follow-up letter for the Professional Investors

Dear Sir/ Madam

**Professional Investors' Perceptions of Auditors' Independence**

I am writing in reference to a questionnaire survey that was sent to you dated\_\_\_\_\_. The questionnaire was designed to seek Malaysian professional investors' perceptions of auditor independence issues and forms part of my postgraduate research under the supervision of Professor Roy Chandler at Cardiff University, United Kingdom.

If you have already returned the questionnaire, I would like to thank you for your feedback. However, if you have not had the chance to complete the questionnaire, I would be very grateful if you could do so. The questionnaire and post-paid envelope are also attached.

I assure you that views expressed in the questionnaire will be kept completely confidential.

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MASLINA AHMAD

E-mail: [maslina@iiu.edu.my](mailto:maslina@iiu.edu.my)

Phone: 03-61964662/4698

2<sup>nd</sup> follow-up letter for the Loan Officers

Dear Sir/ Madam

**Loan Officers' Perceptions of Auditors' Independence**

I am writing in reference to a questionnaire survey that was sent to you dated\_\_\_\_\_. The questionnaire was designed to seek Malaysian loan officers' perceptions of auditor independence issues and forms part of my postgraduate research under the supervision of Professor Roy Chandler at Cardiff University, United Kingdom.

If you have already returned the questionnaire, I would like to thank you for your feedback. However, if you have not had the chance to complete the questionnaire, I would be very grateful if you could do so. The questionnaire and post-paid envelope are also attached.

I assure you that views expressed in the questionnaire will be kept completely confidential.

Your cooperation is very much appreciated. Thank you.

Yours faithfully,

## **A SURVEY OF PROFESSIONAL INVESTORS' PERCEPTIONS OF AUDITOR INDEPENDENCE IN MALAYSIA**

APPLICATION APPROVED  
RESEARCH ETHICS COMMITTEE  
CARDIFF BUSINESS SCHOOL  
CARDIFF UNIVERSITY

### **Corresponding details:**

#### **MASLINA AHMAD**

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### **Supervisor:**

#### **PROFESSOR ROY CHANDLER**

Accounting and Finance Section  
Cardiff Business School, Cardiff University  
Aberconway Building, Colum Drive  
Cardiff, CF10 3EU  
United Kingdom

### **CONFIDENTIALITY**

THE VIEWS EXPRESSED IN THIS QUESTIONNAIRE WILL BE TREATED AS  
CONFIDENTIAL. NO INFORMATION IDENTIFYING THE RESPONDENTS AND THEIR  
ORGANIZATIONS WILL BE DISCLOSED UNDER ANY CIRCUMSTANCES.



## A Survey of Professional Investors' Perceptions of Auditor Independence in Malaysia

### General Instructions and Information

1. This questionnaire consists of six sections. Please answer all questions in all sections.
2. There are no right or wrong answers – it is your perceptions that are important to the study. Please indicate your opinion by **ticking (✓) the appropriate box**.
3. For the purpose of this study, auditor independence is defined as an unbiased mental attitude of the auditor in making decisions about audit work and financial reporting.

### SECTION 1 – LONG AUDIT TENURE

1. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
A lengthy relationship between an auditor and a client company is a threat to auditor independence.					
A lengthy relationship with an audit client affects my confidence in an auditor's independence.					
In deciding whether to invest in a company, I take into consideration the <u>length</u> of the relationship between the company and its auditor.					
The implementation of audit <u>partner</u> rotation will enhance auditor independence.					
The policy of audit <u>partner</u> rotation should be replaced with a policy of audit <u>firm</u> rotation.					
The likely benefits of audit <u>firm</u> rotation exceed the likely benefits of audit <u>partner</u> rotation.					
The implementation of audit <u>firm</u> rotation would add more costs to audit firms and audit clients.					

2. The current audit regulation requires the audit partner to be rotated (within the same audit firm) after a specified period of time. Please state after how many years you believe the audit partner should rotate. Please tick (✓) one box only.

- ☐ 1-2 years      ☐ 3-4 years      ☐ 5-7 years      ☐ 8-10 years  
☐ 11-15 years      ☐ 16-20 years      ☐ 21-25 years      ☐ > 25 years  
☐ Never. I do not support audit partner rotation.

*directional*

3. "Audit firm rotation system should be implemented in Malaysia to replace the current system of audit partner rotation". Based on this statement, please state after how many years you believe the audit firm should rotate. Please tick (✓) one box only.

<input type="checkbox"/> 1-2 years	<input type="checkbox"/> 3-4 years	<input type="checkbox"/> 5-7 years	<input type="checkbox"/> 8-10 years
<input type="checkbox"/> 11-15 years	<input type="checkbox"/> 16-20 years	<input type="checkbox"/> 21-25 years	<input type="checkbox"/> > 25 years
<input type="checkbox"/> Never. I do not support audit <u>firm</u> rotation policy.			

## SECTION 2 –AN AUDITOR'S ECONOMIC DEPENDENCE ON A SINGLE AUDIT CLIENT

4. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Income from audit fees received from a single audit client could cause an audit firm to become economically dependent upon that client.					
Even though an audit firm is economically dependent upon its audit client, it could still maintain its independence from that client.					
In deciding whether to invest in a company, I take into consideration the amount of audit fees the company pays to its auditor.					
When an audit partner's income is dependent on total fees generated from a single audit client, his/her ability to remain independent would be affected.					
My investment decisions for a company would be affected if I perceive its auditors to be economically dependent upon it.					

5. As a safeguard to auditor independence, the Malaysian Institute of Accountants has ruled that income generated from a listed audit client should not exceed 15% of audit firm's total income (audit and non-audit). To what extent do you agree that the current limit is sufficient to safeguard auditor independence?

Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree

If you answer "**Disagree**" or "**Strongly Disagree**", please state at what limit you believe this should be. Please tick (✓) one box only.

<input type="checkbox"/> Less than 15%	<input type="checkbox"/> 16% - 20%	<input type="checkbox"/> 21% - 30%	<input type="checkbox"/> 31% - 40%
<input type="checkbox"/> 41% - 50%	<input type="checkbox"/> 51% - 75%	<input type="checkbox"/> > 75%	



### SECTION 3 - THE PROVISION OF NON-AUDIT SERVICES TO AUDIT CLIENTS

6. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
When an auditor provides non-audit services to an existing audit client, the auditor may:					
• perform a more efficient and effective audit.					
• have an increased ability to resist client pressure					
• tend to make difficult audit decisions in favor of the client.					
• sacrifice his/her objectivity in order to retain that high non-audit fee-paying client.					
When an auditor provides non-audit services to an existing audit client, my confidence in the auditor's ability to remain independent would be affected.					
In deciding whether to invest in a company, I take into consideration the amount of non-audit fees the company pays to its auditor.					

7. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
In my opinion, auditor independence would be <b>threatened</b> if non-audit services are provided by:					
• the same personnel involved in the audit.					
• personnel from a separate department within the audit firm.					
• a separate firm where the auditors have an interest.					
• the same personnel involved in the audit but full disclosures are made in the client's financial statements.					
Audit firms should be totally banned from providing non-audit services.					
Audit firms should provide non-audit services to non-audit clients only.					
The audit committee's approval should be sought before any non-audit services could be provided by an existing company auditor.					

8. "A maximum **percentage of non-audit fees to total fees** paid by a particular audit client should be prescribed by the accounting regulator to safeguard auditors from relying too much on income from non-audit services". To what extent do you agree with this statement?

Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree

If you answer "**Agree**" or "**Strongly Agree**", please state what is the maximum percentage of non-audit fees to total fees paid by a particular audit client that you believe should be prescribed by the accounting regulator. Please tick (✓) one box only.

- ☐ Less than 15%      ☐ 15% - 20%      ☐ 21% - 30%      ☐ 31% - 40%  
☐ 41% - 50%      ☐ 51% - 60%      ☐ > 60%

9. Please indicate the extent of your agreement that the following types of non-audit services provided by auditors to their audit clients would **threaten** auditor independence.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Bookkeeping and other accounting services					
Financial information system design and implementation					
Assets valuation or appraisal services					
Actuarial services					
Corporate finance services					
Human resources (i.e. recruitment of senior management)					
Investment advice					
Internal audit services					
Litigation support services (i.e. expert witness)					
Dispute resolution services					
Management functions (acting temporarily or permanently as a director/officer of a client)					
Tax services – calculation for preparing accounting entries (i.e. current and deferred tax liabilities/assets)					
Tax services – tax compliance and tax planning					



#### SECTION 4 – EX-AUDITOR EMPLOYMENT WITH AN AUDIT CLIENT

10. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
I am <b>concerned</b> about the independence of:					
• a senior auditor who seeks employment with his/her current audit client.					
• the last audit of the client's financial statements that the senior auditor has conducted prior to joining the client company.					
• the remaining audit engagement team in their future audits after their senior auditor joins the client company.					
In deciding whether to invest in a company, I consider whether any of the senior employees of the company has previously worked with its current auditor.					
If a company hires a senior employee from its audit firm (who was previously a senior auditor), my investment decisions for the company will be affected.					

11. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
When a senior auditor joins a client company, the independence position of the remaining audit engagement team in their future audits would be <b>threatened</b> if:					
• The senior auditor had been an audit partner.					
• The senior auditor was a member of the engagement team, but not an audit partner.					
• The senior auditor's current responsibility at the client company involved preparation of company's accounts.					
• The senior auditor's current responsibility at the client company does <u>not</u> involve preparation of the company's accounts.					

12. The Malaysian Institute of Accountants has imposed a 'cooling-off period' of 2 years before an audit partner could join their former client company (otherwise, the audit firm shall resign as auditor). To what extent do you agree that the 'cooling-off' period of 2 years is sufficient to safeguard the remaining auditors' independence?

Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree

If you answer "**Disagree**" or "**Strongly Disagree**", please state how long you believe the 'cooling-off' period should be. (Please tick (✓) one box only)

<input type="checkbox"/> 6 months	<input type="checkbox"/> 1 year	<input type="checkbox"/> 1 ½ years	<input type="checkbox"/> 2 ½ years
<input type="checkbox"/> 3 years	<input type="checkbox"/> > 3 years	<input type="checkbox"/> Other (Please state) _____	

#### **SECTION 5 – SAFEGUARDS TO AUDITOR INDEPENDENCE**

13. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
In my opinion, the existence of an <u>audit committee</u> may safeguard auditor independence if :					
(a) They are active, by holding more than 3 meetings a year.					
(b) They are responsible for the appointment and reappointment of the external auditors.					
(c) They review and approve audit fees.					
(d) They are composed of a <u>majority</u> of independent and non-executive directors.					
(e) At least one member of the audit committee has accounting and financial expertise.					
(f) There is a compulsory audit committee report that describes their activities and actions taken during the year.					
(g) The external auditors report to and are monitored by the audit committee.					

14. Please refer to **Question 13**. Please indicate if any of the above audit committee's characteristics/functions [(a) to (g)] do you take into consideration in making investment decisions.

(a)	(b)	(c)	(d)	(e)	(f)	(g)	None



15. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
The following actions could <b>safeguard</b> auditor independence:					
• Greater disclosure on non-audit services and non-audit fees paid to external auditor.					
• A total ban on allowing any senior auditor from seeking employment with an audit client.					
• A systematic staff rotation within the audit firms.					
• An independent review of the departing audit senior's work by another audit senior (who is not a member of the audit engagement team)					
• Audit firms should have policies for peer reviews on significant audit decisions.					
The following actions by the relevant <b>regulatory authority</b> could <b>safeguard</b> auditor independence:					
• A peer review program that focuses on audit firms' compliance with audit and ethical standards.					
• Regular inspections of audit documents of public listed companies.					
• Immediate investigations on auditors suspected of non-compliance with audit and ethical standards.					
• Investigations on auditors suspected for violation of audit or ethical standards <u>only</u> upon complaints by the public or referrals by other authorities.					
• Disciplinary actions and sanctions are imposed on auditors who fail to comply with audit and ethical standards.					

16. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
In my opinion, auditors of public listed companies should be regulated by:					
• The accounting profession (i.e the Malaysian Institute of Accountants or other professional accounting bodies).					
• The Audit Oversight Board.					

## SECTION 6 - SOME INFORMATION ABOUT YOU

The answers you give to these questions will help in making statistical analysis more meaningful.

17. How important do you think an audit report is in making investment decisions?

Not important at all	Not Important	Neutral	Important	Very Important

18. Are you:

Male		Female	
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19. What age bracket do you fall into?

30 years or less	31 - 40 years	41 - 50 years	51 - 60 years	Above 60 years

20. Your current job position:

Financial Analyst	Fund Manager	Other (Please specify):

21. Total years of experience in this job:

Less than 5 years	5 - 10 years	11 - 15 years	16-20 years	More than 20 years

22. Highest academic qualification:

Diploma	Bachelor Degree	Master's Degree	PhD	Professional Qualification(s)	Other (Please specify):

23. Please state any professional qualification(s) that you have: \_\_\_\_\_

24. Your academic field of study:

Finance	Accounting	Business	Economics	Other (Please specify):



25. Do you have any work experience in accounting firms as an auditor or accountant in industry?

- ☐ Yes, I worked as an accountant in industry for \_\_\_\_\_ years  
☐ Yes, I worked as an auditor in one of the Big Four (or predecessor) accounting firms for \_\_\_\_\_ years  
☐ Yes, I worked as an auditor in a medium size accounting firm for \_\_\_\_\_ years.  
☐ Yes, I worked as an auditor in a small accounting firm for \_\_\_\_\_ years.  
☐ None.

26. Would you be willing to be contacted for any follow up questions?

YES ☐

NO ☐

If '**Yes**', please provide your name, telephone number and e-mail address.

Name:	Telephone No:	E-mail:
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- ☐ Please tick this box if you would like to receive a summarized analysis of the responses to this questionnaire and leave your contact information (name and e-mail) in the box above.

If you have any comments or suggestions on the issues addressed by this questionnaire, please write them here.  
If needed, please use the blank space at the back of this questionnaire.

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**THANK YOU VERY MUCH FOR YOUR ASSISTANCE IN THIS RESEARCH**

## **A SURVEY OF LOAN OFFICERS' PERCEPTIONS OF AUDITOR INDEPENDENCE IN MALAYSIA**

### **Corresponding details:**

**MASLINA AHMAD**  
Department of Accounting  
Faculty of Economics and Management Science  
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P.O Box 10, 50728, Kuala Lumpur  
E-mail: maslina@iiu.edu.my/  
masmart76@yahoo.com  
Telephone: 03-61964698/4662

### **Supervisor:**

**PROFESSOR ROY CHANDLER**  
Accounting and Finance Section  
Cardiff Business School, Cardiff University  
Aberconway Building, Colum Drive  
Cardiff, CF10 3EU  
United Kingdom

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## A Survey of Loan Officers' Perceptions of Auditor Independence in Malaysia

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3. For the purpose of this study, auditor independence is defined as an unbiased mental attitude of the auditor in making decisions about audit work and financial reporting.

### SECTION 1 – LONG AUDIT TENURE

1. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
A lengthy relationship between an auditor and a client company is a threat to auditor independence.					
A lengthy relationship with an audit client affects my confidence in an auditor's independence.					
In making lending decisions, I take into consideration the length of the relationship between a company and its auditor.					
The implementation of audit <u>partner</u> rotation will enhance auditor independence.					
The policy of audit <u>partner</u> rotation should be replaced with a policy of audit <u>firm</u> rotation.					
The likely benefits of audit <u>firm</u> rotation exceed the likely benefits of audit <u>partner</u> rotation.					
The implementation of audit <u>firm</u> rotation would add more costs to audit firms and audit clients.					

2. The current audit regulation requires the audit partner to be rotated (within the same audit firm) after a specified period of time. Please state after how many years you believe the audit partner should rotate.  
Please tick (✓) one box only.

- ☐ 1-2 years      ☐ 3-4 years      ☐ 5-7 years      ☐ 8-10 years  
☐ 11-15 years      ☐ 16-20 years      ☐ 21-25 years      ☐ > 25 years  
☐ Never. I do not support audit partner rotation.



3. "Audit firm rotation system should be implemented in Malaysia to replace the current system of audit partner rotation". Based on this statement, please state after how many years you believe the audit firm should rotate. Please tick (✓) one box only.

<input type="checkbox"/> 1-2 years	<input type="checkbox"/> 3-4 years	<input type="checkbox"/> 5-7 years	<input type="checkbox"/> 8-10 years
<input type="checkbox"/> 11-15 years	<input type="checkbox"/> 16-20 years	<input type="checkbox"/> 21-25 years	<input type="checkbox"/> > 25 years
<input type="checkbox"/> Never. I do not support audit <u>firm</u> rotation policy.			

## **SECTION 2 –AN AUDITOR’S ECONOMIC DEPENDENCE ON A SINGLE AUDIT CLIENT**

4. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Income from audit fees received from a single audit client could cause an audit firm to become economically dependent upon that client.					
Even though an audit firm is economically dependent upon its audit client, it could still maintain its independence from that client.					
In making lending decisions, I take into consideration the amount of audit fees a company pays to its auditor.					
When an audit partner’s income is dependent on total fees generated from a single audit client, his/her ability to remain independent would be affected.					
My lending decisions for a company would be affected if I perceive its auditors to be economically dependent upon it.					

5. As a safeguard to auditor independence, the Malaysian Institute of Accountants has ruled that income generated from a listed audit client should not exceed 15% of audit firm’s total income (audit and non-audit). To what extent do you agree that the current limit is sufficient to safeguard auditor independence?

Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree

- If you answer “**Disagree**” or “**Strongly Disagree**”, please state at what limit you believe this should be. Please tick (✓) one box only.

<input type="checkbox"/> Less than 15%	<input type="checkbox"/> 16% - 20%	<input type="checkbox"/> 21% - 30%	<input type="checkbox"/> 31% - 40%
<input type="checkbox"/> 41% -50%	<input type="checkbox"/> 51% - 75%	<input type="checkbox"/> > 75%	

### SECTION 3 - THE PROVISION OF NON-AUDIT SERVICES TO AUDIT CLIENTS

6. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
When an auditor provides non-audit services to an existing audit client, the auditor may:					
• perform a more efficient and effective audit.					
• have an increased ability to resist client pressure					
• tend to make difficult audit decisions in favor of the client.					
• sacrifice his/her objectivity in order to retain that high non-audit fee-paying client.					
When an auditor provides non-audit services to an existing audit client, my confidence in the auditor's ability to remain independent would be affected.					
In making lending decisions, I take into consideration the amount of non-audit fees the company pays to its auditor.					

7. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
In my opinion, auditor independence would be <b>threatened</b> if non-audit services are provided by:					
• the same personnel involved in the audit.					
• personnel from a separate department within the audit firm.					
• a separate firm where the auditors have an interest.					
• the same personnel involved in the audit but full disclosures are made in the client's financial statements.					
Audit firms should be totally banned from providing non-audit services.					
Audit firms should provide non-audit services to non-audit clients only.					
The audit committee's approval should be sought before any non-audit services could be provided by an existing company auditor.					



8. "A maximum **percentage of non-audit fees to total fees** paid by a particular audit client should be prescribed by the accounting regulator to safeguard auditors from relying too much on income from non-audit services". To what extent do you agree with this statement?

Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree

If you answer "**Agree**" or "**Strongly Agree**", please state what is the maximum percentage of non-audit fees to total fees paid by a particular audit client that you believe should be prescribed by the accounting regulator. Please tick (✓) one box only.

- ☐ Less than 15%      ☐ 15% - 20%      ☐ 21% - 30%      ☐ 31% - 40%  
☐ 41% - 50%      ☐ 51% - 60%      ☐ > 60%

9. Please indicate the extent of your agreement that the following types of non-audit services provided by auditors to their audit clients would threaten auditor independence.

The following types of non-audit service would <b>threaten</b> auditor independence.	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Bookkeeping and other accounting services					
Financial information system design and implementation					
Assets valuation or appraisal services					
Actuarial services					
Corporate finance services					
Human resources (i.e. recruitment of senior management)					
Investment advice					
Internal audit services					
Litigation support services (i.e. expert witness)					
Dispute resolution services					
Management functions (acting temporarily or permanently as a director/officer of a client)					
Tax services – calculation for preparing accounting entries (i.e. current and deferred tax liabilities/assets)					
Tax services – tax compliance and tax planning					

#### SECTION 4 – EX-AUDITOR EMPLOYMENT WITH AN AUDIT CLIENT

10. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
I am <b>concerned</b> about the independence of:					
• a senior auditor who seeks employment with his/her current audit client.					
• the last audit of the client's financial statements that the senior auditor has conducted prior to joining the client company.					
• the remaining audit engagement team in their future audits after their senior auditor joins the client company.					
In making lending decisions, I consider whether any of the senior employees of the company has previously worked with its current auditor.					
If a company hires a senior employee from its audit firm (who was previously a senior auditor), my lending decisions for the company will be affected.					Strongly Agree

11. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
When a senior auditor joins a client company, the independence position of the remaining audit engagement team in their future audits would be <b>threatened</b> if:					
• The senior auditor had been an audit partner.					
• The senior auditor was a member of the engagement team, but not an audit partner.					
• The senior auditor's current responsibility at the client company involved preparation of company's accounts.					Strongly Agree
• The senior auditor's current responsibility at the client company does <u>not</u> involve preparation of the company's accounts.					

APPLICATION APPROVED  
RESEARCH ETHICS COMMITTEE  
CARDIFF BUSINESS SCHOOL  
CARDIFF UNIVERSITY



12. The Malaysian Institute of Accountants has imposed a 'cooling-off period' of 2 years before an audit partner could join their former client company (otherwise, the audit firm shall resign as auditor). To what extent do you agree that the 'cooling-off' period of 2 years is sufficient to safeguard the remaining auditors' independence?

Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree

If you answer "**Disagree**" or "**Strongly Disagree**", please state how long you believe the 'cooling-off' period should be. (Please tick (✓) one box only)

<input type="checkbox"/> 6 months	<input type="checkbox"/> 1 year	<input type="checkbox"/> 1 ½ years	<input type="checkbox"/> 2 ½ years
<input type="checkbox"/> 3 years	<input type="checkbox"/> > 3 years	<input type="checkbox"/> Other (Please state) _____	

### SECTION 5 – SAFEGUARDS TO AUDITOR INDEPENDENCE

13. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
In my opinion, the existence of an <b>audit committee</b> may safeguard auditor independence if :					
(a) They are active, by holding more than 3 meetings a year.					
(b) They are responsible for the appointment and reappointment of the external auditors.					
(c) They review and approve audit fees.					
(d) They are composed of a <u>majority</u> of independent and non-executive directors.					
(e) At least one member of the audit committee has accounting and financial expertise.					
(f) There is a compulsory audit committee report that describes their activities and actions taken during the year.					
(g) The external auditors report to and are monitored by the audit committee.					

14. Please refer to **Question 13**. Please indicate if any of the above audit committee's characteristics/functions [(a) to (g)] do you take into consideration in making lending decisions.

(a)	(b)	(c)	(d)	(e)	(f)	(g)	None



15. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
The following actions could <b>safeguard</b> auditor independence:					
• Greater disclosure on non-audit services and non-audit fees paid to external auditor.					
• A total ban on allowing any senior auditor from seeking employment with an audit client.					
• A systematic staff rotation within the audit firms.					
• An independent review of the departing audit senior's work by another audit senior (who is not a member of the audit engagement team)					
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The following actions by the relevant <b>regulatory authority</b> could <b>safeguard</b> auditor independence:					
• A peer review program that focuses on audit firms' compliance with audit and ethical standards.					
• Regular inspections of audit documents of public listed companies.					
• Immediate investigations on auditors suspected of non-compliance with audit and ethical standards.					
• Investigations on auditors suspected for violation of audit or ethical standards <u>only</u> upon complaints by the public or referrals by other authorities.					
• Disciplinary actions and sanctions are imposed on auditors who fail to comply with audit and ethical standards.					

16. Please indicate the extent of your agreement with each of the following statements.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
In my opinion, auditors of public listed companies should be regulated by:					
• The accounting profession (i.e the Malaysian Institute of Accountants or other professional accounting bodies).					
• The Audit Oversight Board.					

## SECTION 6 - SOME INFORMATION ABOUT YOU

The answers you give to these questions will help in making statistical analysis more meaningful.

17. How important do you think an audit report is in making lending decisions?

Not important at all	Not Important	Neutral	Important	Very Important

18. Are you:

Male		Female	
------	--	--------	--

19. What age bracket do you fall into?

30 years or less	31-40 years	41-50 years	51-60 years	Above 60 years

20. Your current job position in loan department:

Manager	Assist. Manager	Senior Officer	Officer	Other (Please specify):

21. Total years of experience in this job:

Less than 5 years	5-10 years	11-15 years	16-20 years	More than 20 years

22. Highest academic qualification:

Diploma	Bachelor Degree	Master's Degree	PhD	Professional Qualification	Other (Please specify):

23. Please state any professional qualification(s) that you have: \_\_\_\_\_

24. Your academic field of study:

Finance	Accounting	Business	Economics	Other (Please specify):



25. Do you have any work experience in accounting firms as an auditor or accountant in industry?

- ☐ Yes, I worked as an accountant in industry for \_\_\_\_\_ years
- ☐ Yes, I worked as an auditor in one of the Big Four (or predecessor) accounting firms for \_\_\_\_\_ years
- ☐ Yes, I worked as an auditor in a medium size accounting firm for \_\_\_\_\_ years.
- ☐ Yes, I worked as an auditor in a small accounting firm for \_\_\_\_\_ years.
- ☐ None.

26. Would you be willing to be contacted for any follow up questions?

YES ☐

NO ☐

If 'Yes', please provide your name, telephone number and e-mail address.

Name:

Telephone No:

E-mail:

- ☐ Please tick this box if you would like to receive a summarized analysis of the responses to this questionnaire and leave your contact information (name and e-mail) in the box above.

If you have any comments or suggestions on the issues addressed by this questionnaire, please write them here.  
If needed, please use the blank space at the back of this questionnaire.

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THANK YOU VERY MUCH FOR YOUR ASSISTANCE IN THIS RESEARCH

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## APPENDIX 2 – ETHICAL APPROVAL FORM

### CARDIFF BUSINESS SCHOOL ETHICAL APPROVAL FORM: PHD THESIS RESEARCH

(For guidance on how to complete this form, please see <http://www.cf.ac.uk/carbs/research/ethics.html>)

For Office Use: Ref	Meeting
<p><b>Does your research involve human participants?</b> Yes <input checked="" type="checkbox"/> No <input type="checkbox"/></p> <p>If you have answered 'No' to this question you do not need to complete the rest of this form, otherwise please proceed to the next question</p>	
<p><b>Does your research have any involvement with the NHS?</b> Yes <input type="checkbox"/> No <input checked="" type="checkbox"/></p> <p>If you have answered 'Yes' to this question, then your project should firstly be submitted to the NHS National Research Ethics Service. Online applications are available on <a href="http://www.nres.npsa.nhs.uk/applicants/">http://www.nres.npsa.nhs.uk/applicants/</a>. It could be that you may have to deal directly with the NHS Ethics Service and bypass the Business School's Research Ethics Committee.</p>	
<p><b>Name of Student:</b> MASLINA AHMAD</p>	
<p><b>Student Number:</b> 0812701</p>	
<p><b>Section:</b> ACCOUNTING AND FINANCE</p>	
<p><b>Email:</b> ahmadmb@cardiff.ac.uk</p>	
<p><b>Names of Supervisors:</b> PROF. ROY CHANDLER</p>	
<p><b>Supervisors' Email Addresses:</b> chandler@cardiff.ac.uk</p>	
<p><b>Title of Thesis:</b> AUDITOR INDEPENDENCE IN MALAYSIA- PERCEPTIONS OF FINANCIAL STATEMENTS USERS (LOAN OFFICERS AND PROFESSIONAL INVESTORS)</p>	
<p><b>Start and Estimated End Date of Research:</b> 1 JULY 2010 TO 15 OCTOBER 2010</p>	
<p><b>Please indicate any sources of funding for this research:</b> FUNDING FROM THE INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA (IIUM)</p>	

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#### 1. Describe the Methodology to be applied in the research

This study investigates the impact of several factors (i.e. non-audit services provided to audit clients, long audit tenure, audit firms' financial dependence on a single audit client, auditor employment with audit clients and existence of audit committee) on financial statements users' perceptions of auditor independence. Based on the literature review, research questions are developed followed by the development of research hypotheses of the current study. The hypotheses test the relationships between the factors mentioned above and the ability of external auditors to be independent in performing financial statements audits.

In order to determine whether the above factors affect auditor independence, this study seeks financial statements users' perceptions. To support hypotheses testing, this study will use a **quantitative approach** mainly due to:

- the study requires a large sample of respondents,
- a wide geographic area must be covered

Thus, a self-completion questionnaire survey method will be employed for data collection. This method is said as the most appropriate approach to seek financial statement users' opinions, attitude and descriptions about the issues under study. The questionnaire will be sent to respondents together with a cover letter describing the purpose of the study (Appendix 1) and inviting them to participate. Two follow up letters will be sent to those who have not responded (Appendix 2).



**2. Describe the participant sample who will be contacted for this Research Project. You need to consider the number of participants, their age, gender, recruitment methods and exclusion/inclusion criteria**

In this study, financial statements users are represented by bank loan officers and professional investors in Malaysia. The literature review revealed that these groups of respondents are among the main users of audited financial statements in making business decisions. Gul (1991) stated that bank loan officers are relatively sophisticated financial statements users who could understand the importance of auditor independence. Mauldin (2003) claimed that professional investors are representative of a reasonable investor whose investing decisions maybe affected if they perceive an independence problem. The professional investors in this study include fund managers, financial analysts and investment analysts.

As at 1 January 2010, there are 9 commercial banks and 11 Islamic banks exist in Malaysia. However, the total population of loan officers is unknown and varied from one bank to another. Gul (1989) used volunteer bank lending officers in his study of perceptions of auditor independence in New Zealand. In Malaysia, Sori (2005) asked for volunteers in his study by approaching the banks' Corporate Affairs Department. The bank officials refused to give the names of loan officers but were willing to distribute 20 questionnaires to volunteers in each bank. Thus, this study adopts similar approach used in Sori (2005). The researcher will briefly explain the objective of the study before requesting the bank representatives to distribute the questionnaires.

Ku Ismail and Chandler (2005) stated that professional investors can be identified in stock-broking firms, fund management companies, investment advisory firms, unit trust fund companies and large public fund organizations. As at 1<sup>st</sup> January 2010, there are 35 stock-broking companies (which consist of 15 investment banks and 20 non-investment banks) with 160 branches, 41 unit trust fund companies and 5 large public fund organizations. Similar to bank loan officers, the number of analysts and fund managers in each organization is unknown. Ku Ismail (2003) sent 3 sets of questionnaire with cover letters to the head of analysts and head of fund managers in her study of professional investors' perceptions of usefulness of quarterly financial reporting in Malaysia. Thus, this study will mail 5 sets of questionnaires to the head of analysts in each investment bank and 3 sets of questionnaires will be sent to the head of analysts or head of fund managers in each of the remaining organizations (to be distributed among their fellow analysts or fund managers). For branches, a lower number of analysts are expected and thus 2 sets of questionnaires will be mailed. It is assumed that sending 5 sets of questionnaires to large organizations such as investment banks, 3 sets of questionnaires to the remaining organizations and 2 sets of questionnaire to branches are reasonable.

**3. Describe the consent and participant information arrangements you will make, as well as the methods of debriefing. If you are conducting interviews, you must attach a copy of the consent form you will be using.**

In this study, no consent arrangement will be made since consent is given by the respondents implicitly through the completion of the questionnaire. The cover letter explains the objective of the study, why the respondents' opinions are important and an assurance of confidentiality. The assurance of confidentiality is emphasized again on the first page of the questionnaire. Thus, they are encouraged to complete the questionnaire and their consent is considered obtain when they agree to fill up and return the questionnaire. Debriefing will be provided through a document comprising a summary of the research findings once the study is completed.

**4. Please make a clear and concise statement of the ethical considerations raised by the research and how you intend to deal with them throughout the duration of the project**

The purpose of the study is explained in the cover letter and the need for respondents' opinions, due to the topic of this research, is unlikely to cause any harm to them. In this study, respondents' anonymity may not be achieved since the study will send follow up letters to those who have not responded. A special code will be included in the questionnaire to achieve this purpose. This information is explained clearly in the cover letter in order to avoid respondents from feeling deceived. The respondents are also invited to receive a summary of the research findings and to do so they must complete their contact details on the questionnaire. The cover letter ensures that any information that is received from the participants will be treated in complete confidence. Implicit consent is considered obtain when they complete the questionnaire. The researcher's contact details are also given in the questionnaire for the respondents to make contact for further information.

**PLEASE NOTE that you should include a copy of your questionnaire**

**NB: Copies of your signed and approved Research Ethics Application Form together with accompanying documentation must be bound into your Dissertation or Thesis.**



5. Please complete the following in relation to your research:

		Yes	No	n/a
(a)	Will you describe the main details of the research process to participants in advance, so that they are informed about what to expect?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(b)	Will you tell participants that their participation is voluntary?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(c)	Will you obtain written consent for participation?	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
(d)	Will you tell participants that they may withdraw from the research at any time and for any reason?	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
(e)	If you are using a questionnaire, will you give participants the option of omitting questions they do not want to answer?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
(f)	Will you tell participants that their data will be treated with full confidentiality and that, if published, it will not be identifiable as theirs?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(g)	Will you offer to send participants findings from the research (e.g. copies of publications arising from the research)?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

**PLEASE NOTE:**

If you have ticked **No** to any of 5(a) to 5(g), please give an explanation on a separate sheet.

(Note: N/A = not applicable)

There is an obligation on the lead researcher to bring to the attention of Cardiff Business School Ethics Committee any issues with ethical implications not clearly covered by the above checklist.

*Two copies of this form (and attachments) should be submitted to Ms Lainey Clayton, Room F09, Cardiff Business School.*

Signed

Print Name MASLINA AHMAD

Date 20<sup>th</sup> MAY 2010

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**SUPERVISOR'S DECLARATION**

As the supervisor for this research I confirm that I believe that all research ethical issues have been dealt with in accordance with University policy and the research ethics guidelines of the relevant professional organisation.

Signed

Print Name

Date

(Primary supervisor)

**STATEMENT OF ETHICAL APPROVAL**

This project has been considered using agreed School procedures and is now approved.

Signed

Print Name

Date

(Chair, School Research Ethics Committee)

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