



UNIVERSITI PUTRA MALAYSIA

***IMPACT OF PERCEIVED AUDITOR INDEPENDENCE ON GOING
CONCERN AUDIT OPINIONS FOR FINANCIALLY DISTRESSED
COMPANIES IN MALAYSIA***

D. JOYCE CHRISTINA DHARMARAJ

GSM 2018 36



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CONCERN AUDIT OPINIONS FOR FINANCIALLY DISTRESSED
COMPANIES IN MALAYSIA**

By

D. JOYCE CHRISTINA DHARMARAJ

**Thesis Submitted to Graduate School of Management, University Putra
Malaysia, in Fulfilment of the Requirements for the Degree of
Doctor of Philosophy**

September 2016



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DEDICATION

*In memory of my precious father, Mr. Dharmaraj Gnamuthu and
loving mother, Mrs. Anbu Theyy Kovilpillai.*



Abstract of thesis presented to the Senate of Universiti Putra Malaysia in fulfilment of the requirements for the degree of Doctor of Philosophy

IMPACT OF PERCEIVED AUDITOR INDEPENDENCE ON GOING CONCERN AUDIT OPINIONS FOR FINANCIALLY DISTRESSED COMPANIES IN MALAYSIA

By

D. JOYCE CHRISTINA DHARMARAJ

September 2016

Chairman: Nur Ashikin Binti Mohd Saat, PhD
Faculty: Graduate School of Management, UPM

With the public outcry over the corporate scandals across the world, such as Enron and WorldCom in the U.S., as well as Transmile and Silverbird in Malaysia, the notion of auditor independence has received substantial attention from the profession and regulatory bodies worldwide. These scandals involving listed companies have highlighted concerns of regulators and other interested parties relating to threats towards auditor independence. In Malaysia, the Malaysian Code on Corporate Governance (MCCG) was introduced in March 2000 (revised in 2017) as a result of recommendations made by the Finance Committee on Corporate Governance (FCCG). MCCG highlights the need to reinforce the independence of the external auditor.

However, it is noted that when organisations are in financial distress, auditors do not provide signals of potential distress, i.e. Type II Misclassification, which triggers independence of the auditors. Hence, there is a need for identification of determinants of auditor independence that leads to impairment and compromisation of perceived auditor independence to maintain the credibility of the auditing profession. It is necessary to develop a tool to assess auditor independence based on observable data from published reports. It is also critical to investigate the relationship between auditor independence and the going concern audit opinions for financially distressed companies in Malaysia to understand how to increase confidence and rebuild trust in audit opinions of financial statements, which are important to ensure capital market growth.

In this study, twenty four publicly available variables were used to examine the determinants of auditor independence in financially distressed

companies. A total of 750 questionnaires were distributed among accountants (MIA-registered practitioners) to capture auditors' perception on auditor independence since actual independence cannot easily be observed or assessed. The study found that the determinants of auditor independence for financially distressed Malaysian companies are namely, (1) Disclosure and Financial Performance, (2) Relationship-centric, (3) Ethnicity, (4) Assurance Focus, and (5) Transparency Focus.

Based on the findings of this study, Auditor Independence (PAI) Index was developed and validated using Altman's Score. Archival data of 78 financially distressed Malaysian companies (i.e. PN17 companies) in the period between 2007 and 2012 were utilised to compute the respective PAI value. This period was chosen to assess the perception of auditor independence before the release of the revised MCCG 2012 which explicitly addresses the importance of auditor independence. It was found that relationship-centric and ethnicity determinants are statistically significant to predict PAI value using published data. Higher PAI value reflects impaired auditor independence. In addition, the study also revealed that auditor independence has a negative impact on issuance of going concern opinions.

Besides contributing to the literature, this research is useful for policymakers, financial statement users, and audit professionals to understand factors that can impair or compromise auditor independence.

Abstrak tesis yang dikemukakan kepada Senat Putra Business School
sebagai memenuhi keperluan untuk ijazah Doktor Falsafah

**KESAN PERSEPSI KEBEBASAN JURUAUDIT BAGI PENDAPAT AUDIT
USAHA BERTERUSAN UNTUK SYARIKAT YANG MEMPUNYAI
MASALAH KEWANGAN DI MALAYSIA**

Oleh

D. JOYCE CHRISTINA DHARMARAJ

September 2016

Pengerusi: Nur Ashikin Binti Mohd Saat, PhD
Fakulti: Sekolah Pengajian Siswazah Pengurusan, UPM

Skandal korporat seperti Enron dan WorldCom di Amerika Syarikat, dan Transmile dan Silverbird di Malaysia telah membangkitkan isu kebebasan juruaudit bagi mengekalkan kredibiliti profession pengauditan. Bagi mengukuhkan kebebasan juruaudit, Finance Committee on Corporate Governance (FCCG) telah memperkenalkan Malaysian Code on Corporate Governance (MCCG) pada Mac 2000 (disemak semula 2017). Walau bagaimanapun, didapati penyata kewangan yang diaudit tidak menunjukkan sebarang tanda mengenai masalah (contoh, Type II Misclassification) walaupun organisasi menghadapi masalah kewangan. Perkara ini akan menyebabkan keyakinan pada laporan audit akan tergugat jika persepsi kebebasan terjejas. Maka, terdapat keperluan bagi mengenalpasti penentu persepsi kebebasan juruaudit yang membawa kepada kemerosotan dan kompromi kebebasan juruaudit dalam syarikat yang bermasalah bagi mengekalkan kredibiliti profession pengauditan. Satu index bagi mengukur persepsi kebebasan juruaudit diperlukan untuk menilai kebebasan juruaudit berdasarkan maklumat yang dilaporkan secara umum. Selain itu, terdapat keperluan untuk menyiasat hubungan di antara pengeluaran pendapat usaha berterusan audit bagi syarikat yang bermasalah dengan persepsi kebebasan juruaudit.

Tesis ini mengkaji persepsi kebebasan juruaudit bagi syarikat yang mengalami masalah kewangan dengan menggunakan dua puluh empat pembolehubah yang boleh diperolehi daripada laporan yang diterbitkan. Sebanyak 750 soal selidik telah diedarkan di kalangan akauntan (pengamal berdaftar MIA) bagi mengenalpasti persepsi kebebasan juruaudit. Ini kerana kebebasan sebenar tidak dapat diperhatikan atau dinilai dengan mudah. Penentu persepsi kebebasan juruaudit yang telah dikenalpasti ialah:

(1) Pendedahan dan Prestasi Kewangan; (2) Hubungan-Pusat; (3) Etnik; (4) Fokus Jaminan; dan (5) Fokus Ketelusan bagi syarikat yang mengalami masalah kewangan di Malaysia.

Berdasarkan penemuan ini, Indek Persepsi Kebebasan Juruaudit (PAI) telah dibangunkan dan disahkan menggunakan Altman's Score. Sebanyak 78 syarikat yang mengalami masalah kewangan (PN17) bagi tempoh antara 2007 dan 2012 telah digunakan bagi kajian ini untuk mengira nilai PAI Index bagi setiap syarikat tersebut. Tempoh ini digunakan untuk mengenalpasti kebebasan juruaudit sebelum pengeluaran MCCG 2012 yang telah menitikberatkan kebebasan juruaudit. Kajian ini telah mendapati bahawa pembolehubah Hubungan-Pusat dan Etnik mempunyai impak yang signifikan untuk meramal nilai PAI dengan menggunakan data yang diterbitkan. Selain itu, kajian ini juga telah mendedahkan bahawa hubungan diantara kebebasan juruaudit dan pengeluaran pendapat usaha berterusan audit bagi syarikat yang bermasalah adalah secara negatif.

Selain sumbangan kesusasteraan, penyelidikan ini penting bagi pembuat polisi, pengguna penyata kewangan dan profession audit untuk memahami faktor-faktor yang merosakkan atau kompromikan kebebasan juruaudit.

ACKNOWLEDGEMENTS

I wish to thank my committee members who were more than generous with their expertise and precious time. Special thanks to Dr. Nur Ashikin Binti Mohd Saat, Professor Dr. Zulkarnain Bin Muhamad Sori, and Professor Dr. Murali Sambasivan for their countless hours of reflecting, reading, encouraging, and most of all patience throughout the entire process.

I would like to acknowledge the Accountants' General Department of Malaysia, the Ministry of Finance, and the Public Service Department for granting me the scholarship to pursue my PhD journey. Special thanks to the members of my division, the Accrual Accounting Implementation Team and development staff for their continuous support.

Finally, I would like to thank my family and friends. A special feeling of gratitude to my loving parents, Dharmaraj Gnamuthu and Anbu Theyv Kovilpillai, for their words of encouragement and support in my PhD journey. My beloved brothers (Ghana Selva Raj, Samuel Mani Raj) and sister (Helen), brother (Jerry) and sisters (Jenny, Shirley) in law, and nieces (Ezrynn Joy, Shalynn, Jesreena) and nephews (Joel Dharmaraj, Shazzron Raj, Jerickraj) and their families who have supported me throughout the process. Special thanks to Dr. Grace Mui, for being there for me to support me and be my personal cheerleader.

I certify that a Thesis Examination Committee has met on 20 September 2016 to conduct the final examination of D. Joyce Christina Dharmaraj on her thesis entitled “ Impact of Perceived Auditor Independence on Going Concern Audit Opinions for Financially Distressed Companies in Malaysia” in accordance with the Universities and University Colleges Act 1971 and the Constitution of the University Putra Malaysia [P.U.(A) 106] 15 March 1998. The Committee recommends that the student be awarded the degree of Doctor of Philosophy

Members of the Thesis Examination Committee were as follows:

Junaina Muhammad, PhD

Senior Lecturer
Faculty of Economics & Management
Universiti Putra Malaysia
Serdang, Selangor
(Chairman)

Ku Izah Ku Ismail, PhD

Professor
College of Business
Universiti Utara Malaysia
(External Examiner)

Zakiah Muhammaddun Mohamed, PhD

Associate Professor
School of Accounting
Faculty of Economics and Management
Universiti Kebangsaan Malaysia
(External Examiner)

Roszaini Haniffa, PhD

Professor
School of Management and Languages
Heriot Watt University
United Kingdom
(External Examiner)

PROF. DR. M. IQBAL SARIPAN

Deputy Vice Chancellor (Academic & International)
Universiti Putra Malaysia

Date:

On behalf of,
Graduate School of Management, UPM

This thesis submitted to the Senate of University Putra Malaysia has been accepted as fulfilment of the requirement for the degree of Doctor of Philosophy.

The members of the Supervisory Committee are as follows:

Nur Ashikin Binti Mohd Saat, PhD

Senior Lecturer
Faculty of Economics and Management
University Putra Malaysia
(Chairman)

Zulkarnain Bin Muhamad Sori, PhD

Professor
INCEIF
Kuala Lumpur
(Member)

Murali Sambasivan, PhD

Professor
Taylor's Business School
Taylor's University College
(Member)

PROF. DR. M. IQBAL SARIPAN

Deputy Vice Chancellor (Academic & International)
Universiti Putra Malaysia

Date:

On behalf of,
Graduate School of Management, UPM

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Name and Matric No.: D. Joyce Christina Dharmaraj (GM 03573)

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Chairman of Supervisory Committee

Signature : _____
Name : Dr. Nur Ashikin Mohd Saat
Faculty : Faculty of Economics and Management, UPM

Member of Supervisory Committee

Signature : _____
Name : Prof. Dr. Zulkarnain Muhammad Sori
Faculty : INCEIF, KL

Signature : _____
Name : Prof. Dr. Murali Sambasivan
Faculty : Taylor's Business School, Taylor's University

TABLE OF CONTENTS

ABSTRACT	i
ABSTRAK	iii
ACKNOWLEDGEMENTS	v
APPROVAL	vi
DECLARATION	viii
LIST OF CHARTS	xv
LIST OF TABLES	xvi
LIST OF FIGURES	xvii
LIST OF ABBREVIATIONS	xviii

CHAPTER 1

INTRODUCTION	1
1.1 Background	1
1.2 The Problem Statement	3
1.3 Scope and Methodology	4
1.4 Objectives of the Study	5
1.5 Research Questions	6
1.6 Contribution of The Study	6
1.6.1 Policy	6
1.6.2 Research	6
1.6.3 Practical	6
1.6.4 Audit Profession	7
1.6.5 Managerial	7
1.7 Summary of Chapters	7

CHAPTER 2

LITERATURE REVIEW	10
2.1 Introduction	10
2.2 Auditing Profession	10
2.3 Auditor-Client Relationships	11
2.4 Auditor Independence	12
2.4.1 Auditor Characteristics	14
2.4.1.1 <i>Non-Audit Services (NAS)</i>	14
2.4.1.2 <i>Fee Dependency</i>	17
2.4.1.3 <i>Auditor Ethnicity</i>	19
2.4.1.4 <i>Auditor Tenure</i>	20
2.4.1.5 <i>Audit Firm Size</i>	21
2.4.2 Client Characteristics	22
2.4.2.1 <i>Director Ethnicity</i>	23
2.4.2.2 <i>Board Independence</i>	23
2.4.2.3 <i>Shareholder Majority</i>	25
2.4.2.4 <i>Ownership Structure</i>	25
2.4.2.5 <i>Client Size</i>	27
2.4.3 Audit Committee	27
2.4.3.1 <i>Audit Committee Expertise</i>	28

2.4.3.2	<i>Size of Audit Committee</i>	29
2.4.3.3	<i>Audit Committee Activity</i>	29
2.4.4	Reporting/Disclosure	30
2.4.4.1	<i>Accounting Restatements</i>	30
2.4.4.2	<i>NAS Disclosure</i>	31
2.4.4.3	<i>Credit Rating Disclosure</i>	32
2.4.4.4	<i>Whistle Blowing Policy Disclosure</i>	32
2.4.4.5	<i>Material Level Disclosure</i>	33
2.4.5	Financial Performance	33
2.4.5.1	<i>Current Ratio</i>	33
2.4.5.2	<i>Debt Ratio</i>	34
2.4.5.3	<i>Receivables, Growth and Inventory Ratios</i>	34
2.4.5.4	<i>Recurring Operating Losses</i>	36
2.5	Going Concern Audit Opinions	40
2.5.1	Going Concern Audit Opinions	40
2.5.2	Type II Misclassifications	42
2.5.3	Proxy by Altman's Model	43
2.6	Rules and Regulations in Malaysia	44
2.6.1	Malaysian Institute of Accountants (MIA) By-Laws	45
2.6.2	Malaysian Code on Corporate Governance (MCCG)	47
2.6.3	Audit Oversight Board (AOB)	47
2.7	Theories	48
2.7.1	Agency Theory	48
2.7.2	Accountability Theory	50
2.8	Chapter Summary	52

CHAPTER 3

RESEARCH METHODOLOGY	53	
3.1	Introduction	53
3.2	Research Framework	54
3.3	Phase One - Identification of Auditor Independence Determinants for Financially Distressed Companies	59
3.4	Phase One - Research Question 1 - Determinants of Auditor Independence	60
3.4.1	Research Question 1	60
3.4.2	Hypothesis Development	60
3.4.3	Primary Data – Survey Data	61
3.4.3.1	Survey Sample	62
3.4.3.2	Survey Development	62
3.4.3.3	Pilot Survey	63
3.4.4	Data Analysis – Survey Data	63
3.4.5	Data Validation – Survey Data	69
3.4.5.1	Normality Check	69
3.4.5.2	Assess the quality of the survey data	70
3.4.5.3	Reliability and validity tests	70
3.4.5.4	Content validity	70
3.4.5.5	Assessment of bias contamination	71
3.5	Phase Two - Development of the Auditor Independence Index	71

3.5.1 Research Question 2	71
3.5.2 Secondary Data – Archival Data	72
3.5.3 Sample	72
3.5.4 Data Analysis	74
3.6 Research Question 3 - Auditor Independence and Going Concern Opinion for Distressed Companies	74
3.6.1 Research Question 3	74
3.6.2 Hypotheses Development	74
3.6.3 Going Concern Audit Opinions (Dependent Variable)	75
3.7 Chapter Summary	77

CHAPTER 4

PHASE ONE – DETERMINANTS OF AUDITOR INDEPENDENCE FOR FINANCIALLY DISTRESSED COMPANIES

4.1 Introduction	78
4.2 Research Question 1	78
4.3 Demographics of the Participants	80
4.3.1 Pilot survey	80
4.3.2 Survey of MIA-registered practitioners	80
4.4 Survey Data	84
4.4.1 Descriptive Statistics	84
4.4.2 Validation of Data	87
4.4.2.1 Normality Check	87
4.4.2.3 Non-response bias	89
4.4.2.4 Common method bias	89
4.5 Identification of the Determinants of Auditor Independence	89
4.5.1 Factor Analysis	91
4.5.2 The Determinants of Auditor Independence	93
4.6 Validation of the Determinants of Auditor Independence	95
4.6.1 Reliability	95
4.6.2 Validity of Sample Size	95
4.7 Findings: Revised Research Framework	96
4.8 Hypothesis Development	97
4.9 Chapter Summary	99

CHAPTER 5

PHASE TWO - DEVELOPMENT OF THE AUDITOR INDEPENDENCE INDEX

5.1 Introduction	100
5.1.1 Research Question 2	100
5.2 Scenario Analysis	102
5.2.1 Opinion about the Auditor Independence Index	104
5.3 Multiple Regression to Develop the PAI Index	106
5.4 Descriptive Statistics	111
5.4.1 Company Demographic Data	111
5.4.2 Company Auditor Demographic Data	113
5.5 Computation of the PAI Index Using Archival Data	114

5.5.1 Type II Misclassification	114
5.6 Validation of the PAI Index Using Archival Data	118
5.6.1 Altman's Z-Score	118
5.6.2 Logistic Regression	119
5.7 Identification of a Cut-off point for Type II Misclassification	121
5.8 Chapter Summary	127
CHAPTER 6	
IMPACT OF AUDITOR INDEPENDENCE ON GOING CONCERN OPINION IN DISTRESSED COMPANIES	128
6.1 Introduction	128
6.1.1 Research Question	130
6.2 Hypothesis development and testing	130
6.3 Chapter Summary	133
CHAPTER 7	
CONCLUSION	134
7.1 Introduction	134
7.2 Research Questions and Results	134
7.3 Contribution	136
7.4 Implications	137
7.4.1 Policy	137
7.4.2 Research	137
7.4.3 Practical	138
7.4.4 Audit Profession	138
7.4.5 Managerial	139
7.5 Limitations	140
7.6 Suggestions for Future Research	141
BIBLIOGRAPHY	142
APPENDIX	161
Appendix 1: MIA By-Laws Section 100 <i>Fundamental principles and conceptual framework</i>	162
Appendix 2: Going Concern Implication on Auditor's Report	163
Appendix 3: Variables Used In the Framework	164
Appendix 4: Statistical Analysis of Normality Test for Survey Data	169
Appendix 5: Statistical Analysis of Harman's Single Factor Test	170
Appendix 6: Validity of Minimum Sample Size	171
Appendix 7: List of Companies Classified as PN17	172
Appendix 8: Analysis of Type of Audit Firm (Detailed)	175
Appendix 9: Statistical Analysis of Independence Test	176
Appendix 10: List companies by comparison of Altman's Z-score, Signals for Going Concern and Type II Misclassification	177
Appendix 11: Statistical Analysis of the Logistic Regression – SIGNAL BANKRUPT	181

Appendix 12: Statistical Analysis of the Logistic Regression – Type II Misclassification	182
Appendix 13: Data Collection Form	183
Appendix 14: Questionnaire	188

BIODATA OF THE CANDIDATE	195
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LIST OF CHARTS

Chart 1: Survey Participant Data – Opinion on Auditor Independence Index

104



LIST OF TABLES

Table 1: Literature-Defined Variables' Direction of Impact on Perceived Auditor Independence	36
Table 2: Literature-Defined Categories of the Measures of Auditor Independence	57
Table 3: Variables of Auditor Independence in Financially Distressed Malaysian Companies	66
Table 4: Coding of Variables	68
Table 5: Types of Audit Opinion	75
Table 6: Matrix of Signals for Going Concern and Non-Going Concern Opinions	76
Table 7: Sample Selection of sample MIA-registered Audit Firms	81
Table 8: Analysis of Survey Responses	82
Table 9: Demographic Data of Survey Participants	83
Table 10: Descriptive Statistics for Independent Variables	85
Table 11: Skewness and Kurtosis Test for Auditor Independence Variables	88
Table 12: Correlation Matrix between Independent Variables	90
Table 13: Eliminated Indicators Listed by Construct	91
Table 14: Rotated Components Matrix	92
Table 15: Revised Variables of Auditor Independence	94
Table 16: Cronbach's α Reliability Coefficient for Each Determinant	95
Table 17: Analysis of Perception on the Threat of Auditor Independence	102
Table 18: Paired Sample Statistics	103
Table 19: Paired Sample Correlations	103
Table 20: Responses if 'Yes' for ' Auditor Independence Index will make a contribution to the users'	105
Table 21: Responses if 'No' for ' Auditor Independence Index will make a contribution to the users'	106
Table 22: Model Summary for Multiple Regression	108
Table 23: ANOVA Table for Multiple Regression	108
Table 24: Coefficients Table for Multiple Regression	109
Table 25: PAI Index Range	110
Table 26: Selected PN17 Companies by Sectors	112
Table 27: Company Demographic Data	112
Table 28: Company Auditor Demographic Data	113
Table 29: Analysis of Issuance of Audit Opinion	115
Table 30: PN17 Companies with PAI Index Values	115
Table 31: Analysis of Auditor Independence Values	117
Table 32: Analysis of PN17 companies based on Altman's Z-Score	118
Table 33: Hosmer and Lemeshow Test – SignalBankrupt	120
Table 34: Hosmer and Lemeshow Test - Type II Misclassification	122
Table 35: Classification Table with Cut-Off Point Equal to 0.5	123
Table 36: Sensitivity and Specificity of Model with Different Cut-Off Points	124
Table 37: Hosmer and Lemeshow Test – Issuance of Going-Concern Opinion	131
Table 38: Variable in Equation – Issuance of Going-Concern Opinion	132

LIST OF FIGURES

Figure 1: The Structure and Design of the Study	9
Figure 2: Overview of the Research Design	55
Figure 3: Framework – Literature-Defined Determinants of Auditor Independence	56
Figure 4: Framework – Auditor Independence and Going Concern Opinion	57
Figure 5: Overview of the Research Design for Phase One	79
Figure 6: Framework - Auditor Independence and Going Concern Opinion	97
Figure 7: Overview of the Research Design for Phase Two	101
Figure 8: Best Find Cut-Off Point that Maximises the Minimum of Specificity and Sensitivity Degree	125
Figure 9: ROC Curve	126
Figure 10: Overview of the Research Design for Research Question 3	129

LIST OF ABBREVIATIONS

AGM	- Annual General Meeting
AI	- Auditor Independence
AO	- Audit Opinion
ASSRE	- Assurance Focus
BNM	- Bank Negara Malaysia
CCM	- Companies Commission of Malaysia
CPA	- Certified Public Accountants
CPE	- Continuing Professional Education
DISFIN	- Disclosure and Financial Performance
ETHNY	- Ethnicity
GCO	- Going Concern Opinion
IFAC	- International Federation of Accountants
IIA	- Malaysian Institute of Internal Auditors
ISA	- International Standards on Auditing
KLSE	- Kuala Lumpur Stock Exchange
MCCG	- Malaysia Code of Corporate Governance
MIA	- Malaysia Institute of Accountants
MICG	- Malaysia Institute of Corporate Governance
MSA	- Malaysian Standards on Auditing
NAS	- Non-Audit Services
PAI	- Perceived Audit Independence
PN17	- Practice Note 17
ROC	- Relative Operating Characteristics
RSHIP	- Relationship-centric
RM	- Ringgit Malaysia
SC	- Securities Commission
SEC	- Securities and Exchange Commission
SPSS	- Statistical Package for Social Sciences

CHAPTER 1

INTRODUCTION

1.1 Background

Auditor independence is a topic of important concern to many stakeholders in the corporate environment (Adelopo, 2016). Independence is considered to be one of the cornerstones of the profession (Blay & Geiger, 2013; DeFond & Zhang, 2014). It is argued that the independent auditor's opinion adds credibility to the financial statements (Stice & Stice, 2014). Therefore, if auditors are not independent, or do not appear to be independent, their opinions do not add much. The importance of maintaining both "independence in fact" (actual independence) and "independence in appearance" (perceived independence) has been acknowledged by a number of professional accountancy bodies (for example, MIA By-Laws 2011, ICAEW 2006 and AICPA 1988). Since the former element of auditor independence cannot be easily observed or assessed, the latter element of auditor independence has been seen to be more important in protecting the status of the profession in society.

Independence in appearance (hereafter mentioned as perceived auditor independence or auditor independence) is defined as "the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm's, or a member of the audit team's, integrity, objectivity or professional scepticism has been compromised". This definition is also stated in MIA By-Laws Section 290.6.

Corporate failures such as Enron Corporation, World.Com, and Bank Islam in Malaysia, have come under a lot of criticism which emphasized on an auditor's independence and profession. These failures have raised questions regarding the role of auditors in alerting investors, employees, suppliers, customers, and the public. An auditor's main responsibility is to establish an audit in an independent, impartial and objective manner in order to reassure the public that the published financial information is correct (Mohamed & Habib, 2014).

As a result, Malaysia had issued The Malaysian Code on Corporate Governance (MCCG) 2012 underlining the independence of external auditors in Principle 5, "*Uphold integrity in Financial Reporting*". The importance of

auditor independence is reflected in Recommendation 5.2 (MCCG 2012) of which requires 'review and monitor the suitability and independence of external auditors' and written assurance from external auditors which confirms their independence in conducting the audit.

Moreover, Bursa Malaysia Listing Requirements 2001 (Part D, Paragraph 15.22) requires listed companies to appoint a suitable accounting firm to act as its external auditor. Not only that, "auditor" was redefined as 'who registered under section 31O of Securities Commission Act 1993' whereby Section 31 (Securities Commission Act 1993) states the Audit Oversight Board 'may approve or refuse the registration of an applicant as a registered auditor or the renewal of registration of a registered auditor'. This shows that Bursa Malaysia¹ is also interested in enhancing auditor independence through the implementation of MCCG 2012.

Professional accounting associations and many government regulatory agencies throughout the world have emphasized that auditor independence is both an ethical and a professional issue, crucial to auditors. Lawmakers have responded to Enron's collapse by adopting a tough corporate governance law, the Sarbanes-Oxley Act of 2002, which applies to all the companies with stock listed in the U.S. In addition, the New York Stock Exchange (NYSE), NASDAQ, and American Stock Exchange (AMEX) have adopted new corporate governance rules as part of their listing requirements.

Lack of auditor independence affects the credibility of the external auditor (John Ori, 2009; Lowe & Pany, 1995; Pany & Reckers, 1980). If auditor independence is impaired, the reputation of the external auditor could be placed in jeopardy due to legal actions taken by regulatory bodies against the external auditor and decrease confidence in audit reports issued by the external auditor (Schmidt, 2012).

Mainly, when organisations are in financial distress and audited financial statements do not provide signals of potential distress (Type II Misclassification), the credibility of external auditors, *inter alia*, is brought into question. Based on key assumptions of agency theory, external auditors (agents) will act in their own self-interest and may shirk or consume more prerequisites than the ones previously agreed in their contract with the principal when the agent perceives that the contract is not beneficial to them but it can be constrained (Almer, Higgs, & Hooks, 2005).

¹ Bursa Malaysia amended the Listing Requirements which effective from January 3, 2012. For the purpose of the study, archival data of financially distressed Malaysian companies are collected prior to the Listing Requirement.

There are several factors that may affect auditor's independence, such as non-audit services (NAS), fee dependency, auditor tenure, audit firm size, ownership structure, client size, audit committee, disclosures and financial performance. Determinants of perceived auditor independence are (1) Auditor Characteristics, (2) Client Characteristics, (3) Audit Committee, (4) Reporting/Disclosure, and (5) Financial Performance. Although there are many studies (Albaqali & Kukreja, 2017; Ali & Nesrine, 2015; Barlett, 1993; Beattie, Brandt, & Fearnley, 1999; Dart, 2011; Teoh & Lim, 1996) in identifying the variables for auditor independence, little is known about these issues in the context of financially distressed companies (Practice Note 17 (PN17) companies i.e. experiencing financial and operation distress) in emerging markets such as Malaysia.

1.2 The Problem Statement

Audit opinions issued by external auditors are expected to provide early warning signals of potential financial distress. However, Tagesson & Öhman (2015) and Ruiz-barbadillo et al. (2004) reported that only 21.8% and 4%, respectively of financially distressed companies are more likely to issue going concern warnings from auditors which leads to the issuance of Type II Misclassification. Type II Misclassification occurs when the auditor does not issue a going concern opinion prior to the client being subsequently classified as PN17, i.e., financially distressed. The failure of the audit opinion to highlight the potential for bankruptcy will diminish investors' confidence in the credibility of financial reporting by public listed companies (Geiger et al., 2005, Myers et al., 2013) which could potentially reduce the development of the capital market and reduce investments by sophisticated investors. Moreover, the collapse of high-profile companies such as Enron and WorldCom in U.S., as well as Transmile and Silverbird in Malaysia has led to major criticisms of the audit profession. It was reported that these failures were due to the provision of false or misleading financial statements to users due to lack of auditor independence (Faboyede and Mukoro, 2012).

The release of MIA By-Laws on Professional Independence on 1st July 2004 shows that Malaysia is seriously attending to auditor independence issues as these issues affect the audit profession. Perceived auditor independence refers to the avoidance of facts and circumstances that would lead a reasonable user to conclude that the auditor would not be capable of acting without bias (Dopuch et al., 2003). Hodge (2003) reports that financial scandals have a negative effect on the perception of independence, regardless of whether auditors acted independently and concluded from the results that the users did believe auditors have become more biased and the public did not trust the audit report. If the perception of independence is not taken care of, the audit profession can be destroyed as companies' accounts are perceived as untrustworthy and unreliable. Although several published studies have been conducted on factors affecting perception of auditor independence such as Non-Audit Service (Adeyemi & Olowookere, 2012;

Ahadiat, 2011), fee dependency (Al-Ajmi & Saudagaran, 2011; Alleyne, Devonish, & Alleyne, 2006), auditor ethnicity (Ayoib, Houghton, & Nor Zalina, 2006), and the effect of political connection (Abdul Wahab, Mat Zain, & Abdul Rahman, 2011), these studies only focused on the general effect of a selection of factors on perception of auditor independence. Due to the outbreak of financial scandals involving Malaysian listed companies and subsequent reforms in auditing and corporate governance practices, this study aims to provide further understanding and to identify a set of determinants of auditor independence for Malaysia companies, especially in the context of financially distressed companies.

Therefore, there is an urge to study the determinants of auditor independence including ethnicity and political connection as Malaysia provides an interesting environment to study these determinants due to its unique institutional and political economy as it offers clearly identifiable capital segments divided along ethnic lines (Puan, Kent, & Clarkson, 2006). There is also an urge to develop an index, a tool for decision-makers (stakeholders) to assess perceived auditor independence based on observable data from published reports. This index is necessary as a measurement tool because regulators and By-Laws emphasizes auditor independence and aims to increase the independence of auditors. Perception of auditor independence is the underlying foundation of stakeholder's trust in the auditing profession. Currently, there is no known tool that is being developed in Malaysia or globally to measure the perception of auditor independence.

Moreover, most studies are focused on individual variables such as non-audit services, auditor tenure, and audit committee for the accuracy of the audit opinion in signalling the going concern status (Carson et al., 2013). This study continues to use the Auditor Independence Index value to link with the issuance of Going Concern Opinions in financially distressed Malaysian companies because audit opinions are expected to provide early warning signals of potential financial distress. This study fills the gap on the relationship between perception of auditor independence based on published reports and issuance of Going Concern Opinions in financially distressed Malaysian companies. It is important for users to trust the audit opinion of financial statements which ensures capital markets continue to flourish and grow.

1.3 Scope and Methodology

The research methodology adopted in this study was empirical analysis. Auditor independence (PAI) Index was developed in this study using survey data and annual reports. A list of public listed companies that were financially distressed was obtained from the Bursa Malaysia website. Value for PAI Index was generated using published data from companies.

A survey was carried out where practitioners registered with the Malaysian Institute of Accountants (MIA) determined the auditor independence variables. Auditors were selected to capture auditor's perception on auditor independence because real independence cannot easily be observed or assessed.

The survey included both auditor and client variables of auditor independence which were categorized into (1) Auditor Characteristics; (2) Client Characteristics; (3) Audit Committee; (4) Reporting/Disclosure; and (5) Financial Performance. The determinants of auditor independence were identified using exploratory factor analysis. This study also investigated the impact of the determinants of auditor independence on the issuance of going concern audit opinions by external auditors for public listed companies.

This study was conducted in the context of Malaysian public listed companies that are financially distressed, i.e. PN17, in the period between 2007 and 2012. This period was selected since it was the period prior to the release of the Malaysian Code on Corporate Governance 2012 that had a specific focus on auditor independence. Hand-collected archival data was employed for this study. Regression models were developed to test the relationship between the determinants of auditor independence and Type II Misclassifications arising from the issuance of going concern audit opinions by external auditors. The triangulation of survey data and archival data resulted in a more comprehensive perspective of this relationship.

1.4 Objectives of the Study

The main objective of this study is to develop the Auditor Independence Index (PAI Index). The study also identifies the determinants of auditor independence for financially distressed companies in Malaysia and investigates the relationship between the issuance of going concern audit opinions for financially distressed companies and auditor independence.

In order to achieve these research aims, the following objectives were formulated:

- (1) To examine the determinants of auditor independence in financially distressed Malaysian companies;
- (2) To develop the Auditor Independence Index for financially distressed Malaysian companies;
- (3) To determine the relationship between auditor independence and the issuance of going concern opinions in financially distressed Malaysian companies.

1.5 Research Questions

The research questions are:

- (1) What are the determinants of auditor independence in financially distressed Malaysian companies?
- (2) What is the developed Auditor Independence Index for financially distressed Malaysian companies?
- (3) What is the relationship between auditor independence and the issuance of going concern opinions in financially distressed Malaysian companies?

1.6 Contribution of The Study

1.6.1 Policy

The research is useful to policymakers (i.e. Bursa Malaysia, Bank Negara Malaysia, Audit Oversight Board) considering the changes to Malaysia accounting regulations for the prevention of future 'Enron Style' accounting scandal. The identified auditor independence elicits the perceptions of the primary users of audited financial statements on the auditor independence. This information has the potential to assist stakeholders such as Audit Oversight Board (AOB), when making or adjusting policies regarding issues related to auditor independence.

1.6.2 Research

Further, current research extends the existing auditor independence literature by developing an Auditor Independence (PAI) Index for financially distressed companies. This PAI Index is applicable to Malaysian research because it provides a comprehensive overview of the variables that affect auditor independence and provides a cut-off point to decide whether to accept the audit opinion or not. This can potentially lead to the development of a framework on auditor independence in Malaysia.

1.6.3 Practical

This study builds upon the findings of Carson *et al.*, (2013) on the accuracy of going concern opinions by investigating going concern audit opinions as a signal of financial distress. The investigation of the relationship between the issuance of going concern audit opinions for PN17 companies and the auditor independence variables from the above mentioned PAI Index

provides a potential guide for future research into the assessment of the reliability of the issued audit opinion as a signal of potential distress.

The PAI Index also informs stakeholders (i.e. investors) of non-financial indicators of financial distress. Moreover, the investigation of the relationship between the issuance of going concern opinions for PN17 companies and auditor independence provides the stakeholders (i.e. investors) with a guide to assess the reliability of the issued going concern opinion as a signal of potential distress.

1.6.4 Audit Profession

The PAI Index is developed for Malaysia because it incorporates additional variables, such as ethnicity and political connection. This index provides the audit profession with an understanding of the factors that can enhance or impair auditor independence. PAI Index can be a tool to measure their perception of auditor independence among the stakeholders.

1.6.5 Managerial

The determinants of auditor independence are useful to the board and management of the companies, especially to financially distressed companies. The identified factors can be monitored by the board or management to make sure that it can provide the best practice to make sure that the external auditor can perform the task independently without the perception of impaired auditor independence.

1.7 Summary of Chapters

Chapter 1 presents a brief background and motivation for this study. The primary guidelines (i.e. problem statement, objectives, research questions, and significance) of the study are also stated in this chapter.

Chapter 2 outlines literature review on the external auditor profession in Malaysia and the fundamental theories applied in this study. Auditor independence variables and going concern audit opinions are also further discussed in this chapter.

Chapter 3 addresses the methodological issues related to this study. This chapter outlines the identification of determinants of auditor independence to financially distressed companies in Malaysia; the development and testing of the Auditor Independence Index; and the analysis of the impact of the determinants of auditor independence on going concern audit opinions.

Chapter 4 presents Phase One - the identification of the determinants of auditor independence (Research Question 1) to financially distressed companies in Malaysia. These determinants incorporate additional variables of ethnicity and political connection in addition to variables previously identified in the literature.

Chapter 5 outlines Phase Two – the development of the Auditor Independence Index (Research Question 2). Scenario analysis was employed and was used for the development of PAI Index for financially distressed Malaysian companies. The computation of PAI Index is based on archival data. The PAI Index was validated using archival data and Altman's Z-Score.

Chapter 6 presents the analysis of the impact of the auditor independence and the issuance of the going concern opinion for financially distressed Malaysian companies using logistic regression. The conclusion (Chapter 7) addresses the contributions and limitations of this study. Suggestions for future research are also provided in this chapter.

The structure and design of this study are illustrated in Figure 1.

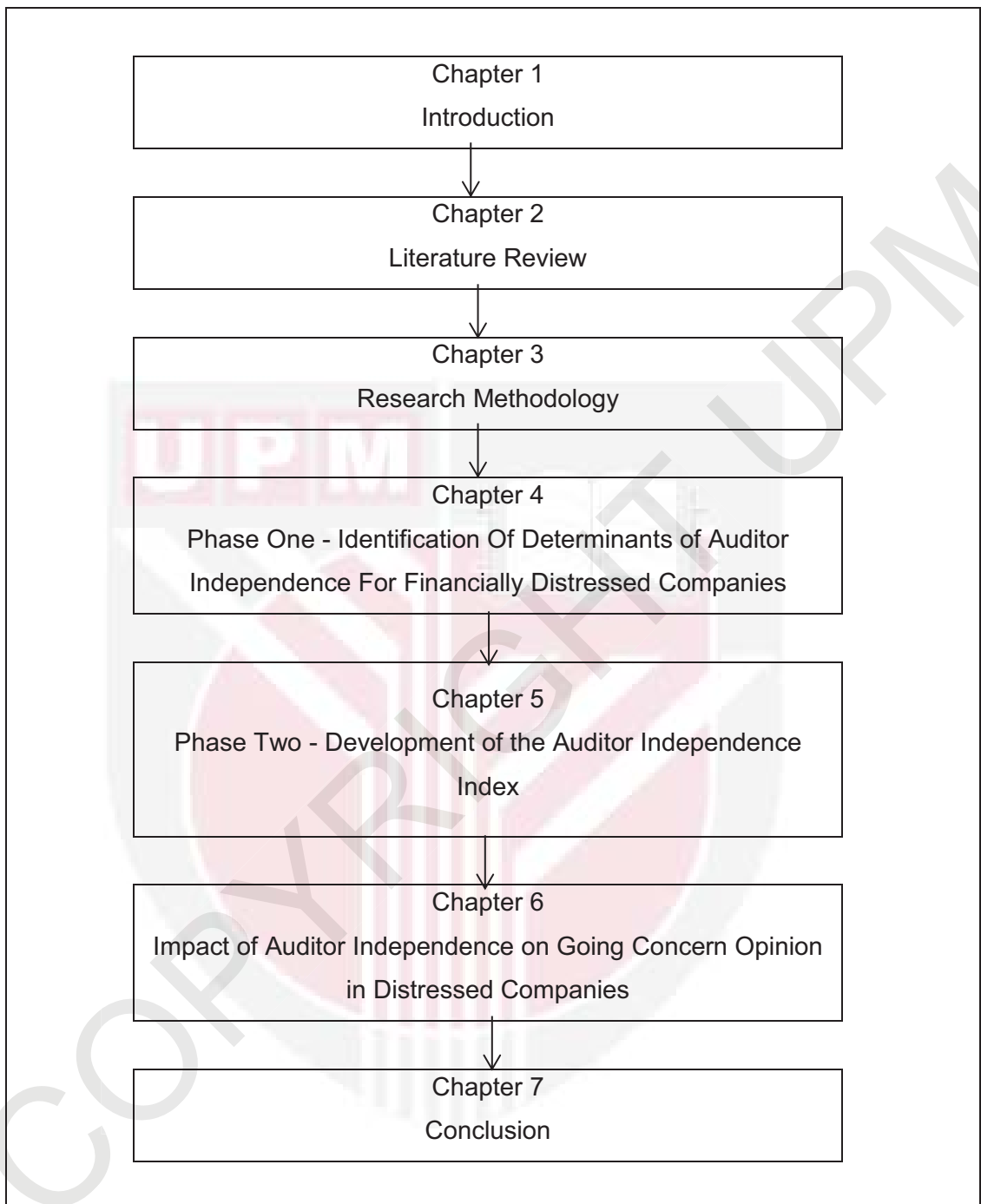


Figure 1: The Structure and Design of the Study

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