

Reasons against Audit Exemption among SME Companies in Malaysia

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Abstract

On 31st January 2017, Companies Act 2016 has been enforced, resulting SME companies to qualify for audit exemption. Thus, the aim of this study is to scrutinize the factors against audit exemption among SME companies in Malaysia. By implementing Agency Theory, the independent variables of this study will be size of the firm, agency factor, management factor and confidence level of third party. The objective of this study is to provide significance information for SME companies to assist their decision, whether to opt for voluntary audit or vice versa. Moreover, future researcher will be advantageous as confidence level of third party is an additional independent variable in our research model. The result show that agency factor (AF), management factor (MF) and confidence level of third party (CL) have a significant relationship with voluntary audit (VA) while size (S) do not have significant relationship with voluntary audit (VA).

Keywords: *Agency factor, Management factor, Confidence level of Third party (CL), Voluntary audit (VA) and Firm size (S)*

1. Introduction

Audit exemption has been an undeniably visible issue in Malaysia since Small and Medium Enterprise (SME) have been given audit exemption through Companies Act 2016. Audit is defined as the examination of the financial statement of an organisation by independent parties. The aim of audit is to present a true and fair view on the information presented in the financial report. Auditors are required to comply with the auditing standard, International Standards on Auditing (ISA) (PricewaterhouseCoopers, 2018).

According to Section 267(2) Companies Act 2016 (Companies Act 2016, 2016), the Registrar of

Companies have the power to exempt selected categories of private company from appointing auditor for every financial year based on the criteria enacted by the Registrar. Based on Practice Directive No.3/2017, private companies that are qualified for audit exemption includes dormant companies, zero-revenue companies and threshold-qualified companies (Suruhanjaya Syarikat Malaysia [SSM], 2017b).

Salleh, Rose, Kumar & Jaafar (2008) research paper is the first known published article that examined the perceptions of auditors on issue regarding audit exemption. According to Haron, Ismail, Ganesan and Hamzah (2016), this uprising issue has been commonly discussed in the Malaysia's auditing industry. Similar issue has been raised up and addressed by developing Western countries such as the United Kingdom (UK), Australia and New Zealand (Kamarudin, Abidin & Smith, 2012). Moreover, SMEs' in European Union countries, Singapore, UK, Australia, New Zealand, and Canada are among the countries that have implemented audit exemptions much earlier than Malaysia (Haron et al., 2016).

The execution of audit exemption on SMEs leads to deliberations and disagreements, as it conveys both benefits and drawbacks to SMEs (Ee, 2017). The major advantage of audit exemption is to reduce the cost burden of SMEs as service fees for audit is disregarded (Salleh et al., 2008). However, 71% of the companies will still persist to opt for audit (Corporate Law Reform Committee [CLRC], 2007). The reason is audited accounts will provide valuable assurance as well as rise the confidence level of the external users (Haapamäki, 2018).

Numerous studies have been conducted by the past researchers to analyse the significance of the issue. Prior empirical studies basically focused on the

directors' viewpoint on factors that might influence the audit exemption and factors that might influence the external auditors' perceptions regarding the audit exemption among SMEs in Malaysia (Othman, Abidin & Thirumanickam, 2013; Salleh et al., 2008).

The audit exemption issue has been addressed widely in studies in UK, Australia, Hong Kong and Singapore, but such studies in Malaysia are scarce (Salleh et al., 2008). Chan (2012) stated that the study on audit exemption in Malaysia is based on the auditors' perceptions on audit exemptions and is carried out by Salleh et al. (2008). The study carried out by Salleh et al. (2008) concluded that, in general, auditors in Malaysia are opposing the audit exemption regulation. The studies of audit exemption in Malaysia context focuses on auditors' perception; hence, it is significant and essential to propose a study to gain understanding on SMEs' point of view on audit exemption.

2. Review of Literature

2.1 Voluntary Audit

Voluntary audit is the dependent variable in this study. Companies Act 2016 had replaced Companies Act 1965 on 31 January 2017 (SSM, 2017a). Before the introduction of Companies Act 2016, all companies are mandatory to have their accounts audited. However, after the introduction of Companies Act 2016, SME companies can opt for voluntary audit, as audited financial reports are no longer mandatory to the SME companies.

The implementation of exemption of audit on financial statements is a dual blade, as it gives pros and cons to the companies (Chan, 2012). According to Chan (2012), the advantage of audit exemption is SME companies can save costs, as audit service is expensive; however, for the audit firms, it is a disadvantage because 92% of the audit firms depend on audit services as their main source of income. Even though audit exemption enables the SME companies to save costs, only minority of 23% reject audit voluntary; 36% wavers to opt for audit voluntary; 41% continue auditing their financial reports (Chan, 2012).

2.2 Size of Firm

According to SME Corporation Malaysia (2016a), the tools to determine the size of the company are sales turnover and number of full-time employees. Collis (2010) conducted a research on the audit exemption and the demand for voluntary audit in UK and Denmark. As reported by Collis (2010), there is a positive relationship between company size and demand for voluntary audit.

Mustapha and Chia (2013) carried out a study to investigate the opinion and expectations of small

business owners on the value of audits to their businesses when they elect for voluntary audit in Malaysia. Mustapha and Chia (2013) found out that company size is positively related with voluntary audit demand. The findings of this study appeared to suggest that the demand for audit is high when the size of the company is large.

Bulatovic & Treis (2016) found out that the size of the company is positively correlated with the demand of voluntary audit. The authors stated that when firm size grows, volume of transaction tends to increase. Errors are more likely to occur in accounting data and financial statement when transaction volume becomes greater.

2.3 Agency Factors

Agency theory is rotated around the issue of agency problem and its resolutions (Panda & Leepsa, 2017). Agency factor is described in the relationship between principal and agent. Agent is someone who monitors and controls the organization whereby principal is the person who separate from the action that carried out by the management, such as owners, external shareholders, bankers and creditors and tax authorities (Collis, 2010). Agency problem between the owner and the managers will be raised as the ownership and control of a firm is separated, which leads to conflict of interest. In order to avoid conflict of interest between principal and agent, voluntary audit is needed; hence, uncertainty can be diminished (Collis, 2010).

A study was carried out by Khairinuddin, Devi and Chan (2012) to investigate the relationship between the ownership structure of SMEs and audit exemption. Based on this research, the ownership structure of SMEs has been classified into non-family owned, partly-family owned and wholly-family owned. The result of study showed that non-family owned company will be more likely to demand for voluntary audit when agency relationship arise.

Furthermore, Mustapha and Chia (2013) had conducted a study to examine the perceptions and expectations of the SMEs' owners in Malaysia on the value of audits to their business when their financial statements are being audited. One of the interviewees indicated that a voluntary audit should be practised by independent auditors in a partnership firm and firms that consist of shareholders. The result of the study indicated that the quality of the financial statements is able to improve when there is voluntary audit practice.

According to the research of Ismail and Loh (2012), it shows that ownership structures have positive impact on perception of small business owners to

have voluntary audit to their business. The owners are likely to have mandatory audit when the firm is not wholly family-owned, where the shareholders could not access to the company's financial information.

2.4 Management Factors

Management factor is the material error found in the financial reports. Material error is plausible to occur in the company due to inherent risk, which is the likelihood that material misstatement arises and control risk, which is the likelihood of the accounting control in detecting the material misstatement. Therefore, audit is opted in order to reduce the error and to check on the internal control of the company (Collis, 2010).

Collis (2010) had conducted a research to prove that voluntary audit has positive relationship with the management factors. The purpose of the research was to identify the factors that influence the decision to have a voluntary audit in small companies in the UK and Denmark.

In addition, Varici (2013) had conducted a research to find out the relationship between information asymmetry and the quality of audit, which lead to audit voluntary. The results showed that the quality of audit has an inverse relationship with information asymmetry and thus, it shows that the high quality of audit means that the board of directors has a high independence.

Clatworthy and Peel (2013) had carried out a research about whether voluntary audit had impact on governance characteristics on accounting errors in private companies. As a result, they had concluded that unaudited accounts are about twice as likely to file annual accounts with errors compared to audited accounts.

2.5 Confidence Level of Third Party

Collis (2004) stated that main recipient of a company accounts will be the external parties such as lenders, Inland Revenue, creditors and customers. Confidence level of third party towards the company is defined as the assurance through the audited financial statements. Therefore, demand for audit on the financial statement is required to enhance the third party's confidence level.

Dedman, Kausar and Lennox (2014) proved that voluntary audit will have the positive effect on credit ratings with creditors and lenders and thus, it will increase the confidence level of shareholders investing into the business.

Besides that, Ojala, Collis, Kinnunen, Niemi and Troberg (2016) had conducted a research to find out whether voluntary audit is needed to ensure the continuity of supplies from suppliers. The results

showed that the voluntary audit will provide assurance about the credibility of financial information to suppliers and thus, it has a positive impact on the continuity of supplies of goods and services.

Othman et al. (2013) had carried out a research about whether the financing strategy acquired by the company is likely to affect the demand for voluntary audit. As a result, they had concluded that lenders, bank officers and potential investors will request the financial statement to be audited as a form of assurance of the company's financial performance.

In the past studies, the confidence level of third party is not shown as an independent variable. However, these past studies have shown that audit is able to enhance the confidence level of lenders, suppliers, creditors, bank officers and investors to the company, which are the third party to a company; hence, third party's confidence level variable is formed. There is a positive relationship between the confidence level of third party and voluntary audit.

3. Theoretical Framework

Economics, political science and various others fields scholars had developed the concepts of agency theory. For instance, in accounting and literature, Cooper (1951) has discussed about the agents presented in the firm; Downs (1957) has discussed about the agents in his economic theory of democracy; agents and delegation to agents has also being referred by Arrow (1963). The concepts of agency theory were incorporated into the agency approach. However, agency theory is created by Stephen Ross and Barry Mitnick in 1973 (Mitnick, 2006).

Agent and principal relationship exists when principal hires agents. Whereas, agency theory discussed about the problems happened when there is delegation of tasks from principals to agents. Principal may be benefited when delegating the tasks to agents who are specialize in performing the task. However, conflict of interest between agent and principal may occur (Lupia, 2001).

Agency theory assumes that individuals are opportunistic and selfish. Principal and agents tend to work in their self-interest. Hence, conflict of interest is inevitable between principal and agent (Seven Pillars Institute, 2018). Agency costs incurred when agents have different interest with the principal and act in their own interest in the expense of principal (Lupia, 2001).

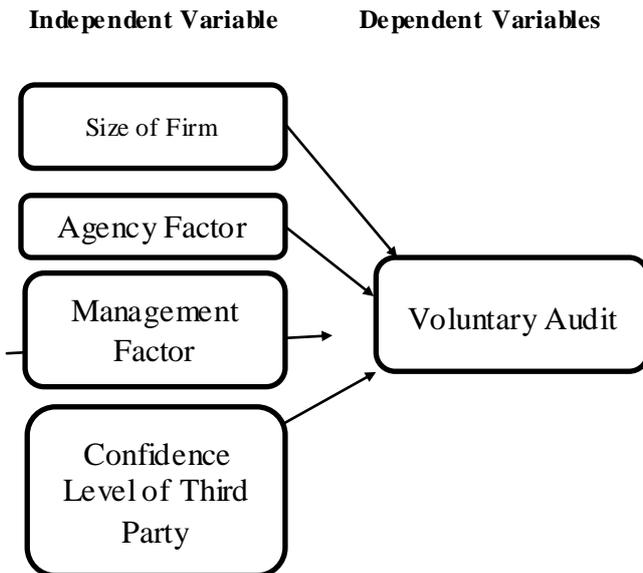
According to Jensen and Meckling (1976), audit provides assurance for the company's financial statement; thus, audit is one of the ways to reduce the agency cost. Hence, company will more likely to opt for voluntarily audit if their agency cost is high.

Agency cost will increase according to the company size, as the monitoring function is more expensive and difficult in a large company compared to small company (Jensen & Meckling, 1976). Management factor occurs as a result of information asymmetry between principal and agent, where one party has contrasting information to others. Through auditing the financial statement, the management factor can be controlled (Goddard & Masters, 2000). Moreover, agency cost will also increase according to the proportion of outside financing; hence, most of the company continues to audit their company's financial reports in order to enhance third party confidence level (Jensen & Meckling, 1976).

Size of the company, management factor, agency factor and confidence level of third party is the independent variables of this study, in order to investigate how these factors affect SME companies in Malaysia to opt for audit.

4. Conceptual Frame work

Figure 1 represents the proposed conceptual model illustrating factors affecting SME companies in Malaysia to opt for voluntary audit.



Adapted from: Ross & Mitnick, (1973)

Figure 1: Factors affecting SME companies in Malaysia to opt for voluntary audit

The target population of this study is SME companies in Malaysia. 400 sets of self-administered survey was distributed to the firm's managerial personnel. The questionnaires was delivered by hand

to each respondents as well as distributed electronically using e-mail.

236 sets of questionnaire are managed to be collected out of 400 sets of survey questionnaire distributed. Hence, the response rate achieved is approximately 59.00 percent. However, during the checking process, the usable survey questionnaires are reduced to 200 sets only due to some incomplete response. The survey questionnaires are further processed for data analysis by using SAS Enterprise Guide 7.1.

5. Results and Discussion

5.1 Pearson Correlati on Coefficient

Table 5.1: Pearson Correlation Coefficient Matrix

Variables	S_AV G	AF_AV G	MF_AV G	CL_AV G	VA_AV G
S_AVG	1.0000				
AF_AVG	-0.0123 0.8628	1.0000			
MF_AVG	0.1518 0.0319	0.3796 <.0001	1.0000		
CL_AVG	0.0285 0.6886	0.3486 <.0001	0.6530 <.0001	1.0000	
VA_AVG	0.0492 0.4892	0.3446 <.0001	0.4390 <.0001	0.4904 <.0001	1.0000

Source: Developed for research

Table 5.1 illustrates the correlation between the variables through Pearson Correlation Coefficient analysis. In overall, the variables are negligible to moderately correlated, as the correlation value are between -0.0123 to 0.6530. The significant correlation exists between CL_AVG and MF_AVG, while the weakest correlation is found between AF_AVG and S_AVG with r = 0.0123 and 0.6530 respectively. The variables are significantly correlated as p-value is less than 0.05 except S (0.4892). Furthermore, there is no multicollinearity problem between all the IVs studied since the correlation value is less than 0.90.

5.2 Multiple Linear Regression (MLR)

Table 5.2: Model Summary

Model	R-square	Adjusted R-square	F Value	Pr > F
	0.2895	0.2749	19.86	<0.0001

Source: Developed for research

Table 5.2 displayed the R-square value for this research model. An r-square value of 0.2895 depicts that 28.95% of the variation in voluntary audit can be explained by all four independent variables. Yet, 71.05% of changes in voluntary audit that can be

explained by other independent variables which are not tested in this study. Similar past studies also achieved r-square ranging from 0.208 to 0.392 (Othman, et al., 2013; Kamarudin et al., 2012; Collis, 2004).

Table 5.2 also sets out the F-value for this research study. F-value of this study is valued at 19.86 with p-value <.0001 (which is less than 0.05), indicating that at least one of the four independent variables can be used to explain voluntary audit. Hence, this has proven that the research model is fit for the purpose of this study.

Table 5.3: Table of Coefficients

Variable	Parameter Estimate	Standard Error	P-Value	Tolerance	Variance Inflation
Intercept	1.2026	0.3433	0.0006	-	0
S_AVG	0.0145	0.0495	0.7697	0.9643	1.037
AF_AVG	0.1874	0.0725	0.0104	0.8348	1.1979
MF_AVG	0.1564	0.0823	0.0591	0.5285	1.892
CL_AVG	0.3308	0.0817	<.0001	0.5577	1.7929

Source: Developed for research

Table 5.3 describes the significance of relationship between the multiple IVs with a single DV. The p-value for AF and CL are less than 0.05, implying that those IVs are significantly related with VA. However, the relationship between S and MF with VA is insignificant since the p-value is 0.7697 and 0.0591 respectively, greater than 0.05. P-value ranging from 0.05 to 0.1 is considered as a trend towards significance (Bangalore & Messerli, 2006). Therefore, there is a significant relationship between MF and VA.

With that, the MLR equation for this model is formulated as follow:

$$VA = 1.2026 + 0.0145 S + 0.1874 AF + 0.1564 MF + 0.3308 CL$$

5.3 Discussions of Major Findings

5.3.1 Size of Firm (S)

The p-value for the relationship between S and VA is 0.7697, which is more than 0.05. Thus, null hypothesis is not rejected. However, this result is in line with few past studies such as Collis (2010), Bulatovic and Treis (2016), Mustapha and Chia (2013).

S would not affect the demand for VA. Company's size would less likely result the demand for VA due to the benefits of audit to the company and the reasonable audit costs. Audited financial statements

are believed to bring advantages by providing reliable financial information to users.

5.3.2 Agency Factors (AF)

AF has a significant relationship with VA since the p-value is 0.0104, which is <0.05. Past studies shows similar hypothesis, such as Khairinuddin et al. (2012), Mustapha and Chia (2013), and Ismail and Loh (2012).

Demand of SMEs for audit varied according to the ownership structures of SMEs (non-family owned, partly-family owned and wholly-family owned). The result shows that family owned business will heavily dependent on audit as it enhances the reliability and quality of the financial information whereas non-family owned will demand for audit when agency problem arises. Thus, audit is necessary to monitor the management's behaviour and to avoid conflict of interest between principal and agents, as shareholders perceived the auditor as an independent party who can help to examine the accounts.

5.3.3 Management Factors (MF)

The significant relationship between MF and VA is empirically supported with p-value equals to 0.0591. According to Bangalore and Messerli (2006), p-value ranging from 0.05 to 0.1 is considered as a trend toward significance. This outcome is consistent with the findings of few researches including Collis (2010), Varici (2013) and Clatworthy and Peel (2013).

Management might demand for voluntary audit to act as a check on internal controls and increase the quality of financial information to users. Management believed that audit reduces the possibility of material errors as inherent risk and control risk is high in small companies. Moreover, information asymmetry between managers and owners can also be eliminated through the existence of audit.

5.3.4 Confidence Level of Third Party (CL)

The result shown that CL and VA is significantly correlated since the p-value is less than 0.0001. This finding is similar to past studies such as of Dedman et al. (2014), Ojala et al. (2016) and Othman et al. (2013).

Audited financial statements are able to provide assurance to users of financial information. When companies need to raise finances from external parties, banks and borrowers might need the audited financial statements to check the credit worthiness of the company. They will demand the financial statements to be audited because it promotes best

assurance on the company's financial performance and to prevent them from suffering financial losses. Moreover, audited financial statements also ensure continuity of supplies of good and services from suppliers and determination of tax liability for tax purposes. Thus, audited financial statement is useful when dealing any transaction with external parties such as banks, creditors, suppliers and governmental agencies.

5.4 Implications of the Study

5.4.1 Theoretical Implications

This research has identified some reasons which have significant relationship with the intention of SME companies to opt for voluntary audit. S, AF, MF and CL are variables that are used in our studies as a predictor of VA, where only S is found to be insignificantly associated with VA. CL is not shown as an IV in the past studies. However, past studies have shown that audit is able to enhance the confidence level of lenders, suppliers, creditors, bank officers and investors to the company, which are the third party to a company (Collis, 2004; Dedman et al., 2014; Ojala et al., 2016; Othman et al., 2013). Hence, CL variable is formed.

This study has adopted Agency Theory, where the CL variable is absent in their research model. In fact, CL was proved by Jensen and Meckling (1976), at which company will continue to audit their company's financial reports in order to enhance third party confidence level. Therefore, in order to better understand the intention of opting for voluntary audit, the scope of research should go beyond the traditional research model. The outcome of this study also shows that CL is significantly related to VA as p-value are less than 0.5. Hence, this study is contributable as the study takes confidence level of third party as one of the key variables.

Furthermore, this research contributes to the scarce study on reasons against audit exemption in Malaysia. The study that has been carried out by Salleh et al. (2008) only emphasis on the auditors' perception on audit exemption. In addition, the research paper written by Mustapha and Chia (2013) restrained their sample size of less than 100 respondents. Thus, in order to overcome the limitations of past studies by Salleh et al. (2008) and Mustapha and Chia (2013), we have collected various SME companies perception regarding audit exemption and a larger sample size are being used.

5.4.2 Managerial/Practical Implications

CL is found to be the construct that has the strongest relationship with VA compared to S, AF and MF, represented by a correlation coefficient of 0.4904. This shows that confidence level of third party has a

significant effect on voluntary audit. A study by Jensen and Meckling (1976) also proved that companies are likely continue to audit their company's financial reports in order to enhance third party confidence level.

Moreover, the research findings from this paper could be beneficial to future researchers to better understand about the factors or reasons SMEs are against audit exemption.

6. Conclusions

The purpose of this study is to investigate the factors against audit exemption among SME companies in Malaysia. Four independent variables, including size of firm, agency factor, management factor and confidence level of third party are adopted in this research. The results from the study show that agency factor, management factor and confidence level of third party have significant influence on the SMEs' intention in opting voluntary audit. However, size of firm is not a significant factor for the SMEs to have voluntary audit.

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