

DEMAND FOR VOLUNTARY AUDIT BY SMALL COMPANIES IN MALAYSIA

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ABSTRACT

Small companies in many foreign countries are exempted from external audit. In Malaysia, companies are obligated to carry out an audit regardless of their size. Only sole proprietorships and partnerships are exempted from this audit. However, some of these businesses opt to audit their accounts. This study attempts to examine the value of auditing for these sole-proprietorships and partnerships. Specifically, the study aims to investigate the perception and expectations of these small business owners on the value of audits to their businesses when they voluntarily have their financial statements audited. Data for the study is obtained from two sources. Primary data is collected through a questionnaire. Interviews are also carried out to better understand the subject under study. About 62 samples are obtained from sole proprietors and partnerships in Malaysia. Multiple regression analysis is used to estimate the relationship between the variables.

The results of the study indicate that owners perceived that the voluntary audit conducted would be able to improve the quality of their financial statements. Among others, the managerial ownership and total number of employees are the characteristics that significantly influence the demand for voluntary audit. The study can be referred as a marketing survey for auditors from small and medium accounting firms in Malaysia which are auditing these small businesses. This study helps them to better understand their customers' demand for audit. They may also develop strategies to attract partners and sole proprietors to choose audit services voluntarily.

This study provides an overview of the perceptions and expectations of small business owners on financial statement audit. This is valuable information to the Malaysian regulatory and professional accounting bodies in their consideration of audit exemption for small companies in Malaysia.

Keywords: *voluntary audit, small businesses, partnership, sole-proprietors.*

Background

Statistics show that small and medium enterprises (SMEs) account for about 99% of the total business establishment and contribute up to 31% of the Malaysian's Gross Domestic Product (National SME Development Council, 2011). This report also claims that SMEs contribute about 56% to total employment and 19% to the total exports of the country. This is supported by an earlier report which claims that SMEs in Malaysia contribute principally to expanding output, providing value-added activities in the manufacturing sector, creating employment opportunities especially in the services sector, and broadening Malaysia's export base (United Nations Development Programme in Malaysia, 2007). Thus, the importance of SMEs in the economic development of the country is undeniable.

These SMEs can exist in three types of organisational forms- corporations, partnership and sole proprietorship (Arrey and David, 2008). All companies are governed under Companies Act 1965, Securities Industries Act 1983 and Registration of Business Act 1956 (Ali and Idris, 2001, pp. 12-14); while partnership and sole proprietorship are governed under the Registration of Business Act 1956. In addition to the Registration of Business Act 1956, partners have to abide by the Partnership Act 1961 (Ali and Idris, 2001, pp. 15).

The enacted provisions of the Companies Act 1965 require that any corporation registered as a company under the Companies Act 1965 in Malaysia must exercise statutory audit annually. Otherwise, the company is deemed to breach the law and is subject to litigation in court. While the Companies Act 1965 mandates external auditing for companies, the Registration of Business Act 1956 and the Partnership Act 1961 (including all amendments up to 1 January 2006) in Malaysia do not require sole

proprietorships or partnerships to audit their financial statements. In other words, sole proprietorships and partnerships registered in Malaysia are, not required by law, to have their financial statements audited every year by external auditors.

It is reported that the total number of businesses (sole proprietorships and partnerships) registered, up to 31 December 2010, is 4,362,124 (*Jumlah Syarikat dan Perniagaan yang Didaftarkan*, 2011). On the contrary, the total number of companies registered up to the same date is 927,045. Implicitly, the statistics indicate that owners of approximate 82% of 5,289,169 business enterprises in Malaysia have a choice as to whether they want to audit their financial statements or not.

Malaysia has wavered in her determination for imposing statutory audit on corporations in the move to improve corporate governance (Abdul Aziz, 2002; Liew, 2007). However, audit exemption for small companies may still be considered in future. The hint of audit exemption in Malaysian business environment can be found in the Final Report of Review of the Companies Act 1965 issued by the Corporate Law Reform Committee (CLRC) in 2003. CLRC (2003) recommends the retention of mandatory audit rules for all companies, but the regulator should be given power to exempt the application of the audit provision for certain types of companies based on certain criteria. The CLRC suggests that the question of whether an audit should remain mandatory needs to be considered from the perspective of its necessity and the value of audited accounts to a particular company's shareholders and the public.

However, there are SME owners that are willing to have their financial statements audited even in an unregulated setting (Hay and Davis, 2002; Collis; 2005; Kaur and Kurt, 2008). Firm-specific incentives (agency and contracting costs) can motivate sole traders and partners to demand for voluntary external auditing when endogenous country characteristics such as the strength of the legal system in contract enforcement are controlled (Francis, Khurana, Martin and Pereira, 2005). Voluntary choice of audit is driven through the benefits derived through monitoring, bonding and other contracting, signalling insiders' knowledge through auditor selection, and organisational control for internal management (Hay and Davis, 2002). In a study by Kaur and Kurt (2008), partnership firms demand for voluntary

audit because partners can focus on their core businesses. Engaging auditors enables partners to free themselves from additional burden and time to maintain the accounting affairs of their businesses (Kaur and Kurt, 2008). As evidence, 28 percent of SME owners express their desire to have advisory services in accounting, finance and audit (Bank Negara Malaysia, 2006). Even with the uncertainties, more and more SMEs in Malaysia may have the possibility to adopt optional audit approach in the future. Despite arising arguments for audit or no audit, there are limited researches conducted on the issue of demand for voluntary audit among Malaysian SMEs. Hence, this research is conducted to bridge the gap of the limited studies on the demand for voluntary audit by SMEs in Malaysia. Specifically, the research aims to investigate both the characteristics of SMEs and the SME owners' perceptions which affect the demand for voluntary audit in the country.

The study provides information relating to the voluntary audit practices in Malaysia since very few studies have been conducted in this area. In addition, it also can be referred to as a marketing survey for auditors from small and medium accounting firms in Malaysia which are auditing these small businesses. This study helps them to better understand their customers' demand for audit. They may also develop strategies to attract partners and sole proprietors to choose audit services voluntarily.

In addition, this study provides an overview of the perceptions and expectations of small business owners on financial statement audit. This is valuable information to the Malaysian regulatory and professional accounting bodies in their consideration of audit exemption for small companies in Malaysia

Literature Review

Demand for Voluntary Audit by Small Companies

In order to reduce high audit fees, many governments have exempted small limited companies in countries such as the United States of America, Canada and Europe from preparing and auditing their financial information so that they can remain competitive and reduce costs of the administrative burden (Arrey and David, 2008). Regardless of the audit exemption given, small

companies still demand for voluntary audit (Collis, 2003). Lots of previous studies have been carried out in other countries to examine the factors that affect the demand for voluntary audit by small companies (Kim et. al., 2010; Arrey and David, 2008; Collis, 2008; Collis, 2005; Seow, 2001; Tauringana and Clarke, 2000). This is because voluntary demand for audit depicts as the intrinsic value stemming from companies revealing that they wish to be audited even in an unregulated environment (Lennox and Pittman, 2011). The decision for voluntary audit sends a positive signal to the public (Lennox and Pittman, 2011).

Characteristics of SMEs in Malaysia and Demand for Voluntary Audit

SMEs in Malaysia are heterogeneous, actively managed by their owners, highly personalised (e.g. owners' preferred management style), largely local in their areas of operations, and largely dependent on internal sources of capital to finance its growth (Hashim and Wafa, 2002).

Based on the Census on Establishment and Enterprises 2005, 88 percent of the SMEs in Malaysia are family-owned businesses (Bank Negara Malaysia, 2006). The owner-managed firms are run more efficiently since owners are more vigilant managers due to their concerns over the performance and running of businesses (Fleming et. al., 2004). According to the theory of the ownership structure of firms by Jensen and Meckling (1976), owners who manage wholly-owned firms will make operating decisions which maximise the firms' utilities. It is further claimed that the demand for voluntary audit decreases as managerial ownership increase (Tauringana and Clarke, 2000). When the shareholders and directors are the same people, it appears that there is no meaning for auditors to report to the shareholders that the directors and the management have prepared the annual financial statements in a true and fair view (Salleh, Rose, Kumar and Jaafar, 2008). Owners of the business firms have direct control over the day-to-day management, and financial statements are being prepared either by them or under their direct supervision (Basu, 2007). They may not be good in bookkeeping, and they accept that their books are somewhat vulnerable to criticism or in a mess (Cox, 1992). Thus, they do not need auditors to tell them that the stewardship of their own assets is acceptable which in return requires twice of the cost in the preparation of their partnership accounts (Cox, 1992). In

addition, owner-managers are reluctant to employ accountants to prepare abbreviated accounts which will cost them even more (Cox, 1992). He also highlights that rigorous audit procedures will lead to qualified audit reports as there are poor quality records and significant owner-manager involvement in running the businesses. The clients will have to bear additional costs to negotiate with auditors so as to get mutual agreement (Cox, 1992). Since the internal control system in a small company cannot be made more reliable without incurring additional costs, most companies compensate for such deficiencies with an increase in supervisory controls (Norris, 1984).

It is also claimed that the size of the business is an important factor in predicting whether the directors consider the cost of having a voluntary audit will outweigh the management and agency benefits (Collis, 2005). Measured relative to revenue, the compliance costs in Malaysia is regressive that they increase in decreasing firm sizes (Loh, Ariff, Ismail, Shamsheer & Ali, 1995). Small companies incur disproportionate costs compared to large companies, suggesting that larger companies are more able to afford higher audit costs (Tauringana and Clarke, 2000). Larger companies are likely to be audited voluntarily because as they grow in size, the volumes of transactions increase, and mistakes are more likely to occur in the accounting data and the financial statements (Tauringana and Clarke, 2000). Furthermore, the economic transactions and the accounting systems have become very complex (Porter, Simon and Hatherly, 2003, pp. 10). Therefore, there is a growing need for the financial statements to be examined by an independent qualified auditor, who has the competence and expertise to understand the entity's business, its transactions, and its accounting systems (Porter et al., 2003). Moreover, the larger the companies are, the more likely they are to have external funding (Collis, 2003).

SME Owners' Perceptions and Demand for Voluntary Audit

Deduced from a study by Collis (2008), 32 percent of small companies qualified for audit exemption persist to perform voluntary audit as the directors perceive the advantages of the practice. The directors require the financial statements to be voluntarily audited for banks or lenders and shareholders (Collis, 2008). However, 61 percent of small companies decide to abandon audit since the directors think that the cost of audit is a major issue in the business (Collis, 2008). Hence, the perceptions of SME owners

on audit are important and can influence their decision making to demand for voluntary audit (Chung and Narasimhan, 2001; Collis, 2008).

Financial statements are perceived as a medium which provides the most useful information to the shareholders (Subramaniam and Raja, 2010). As accounting has become the way firms measure their performance, auditing has also become an increasing need for users of accounting information (Arrey and David, 2008). Irish (1972, pp. 7-8) claims that an audit which is properly conducted can have many advantages to a business, whether it is operated by a sole trader, partnership or a company. The practice should be welcomed by employees and management as an independent review of their work is reflected in the accounts (Irish, 1972, pp. 7-8).

Audit is still perceived as a valuable service by Malaysian users even after the failure of Enron and WorldCom (Fadzly and Ahmad, 2003). Respondents in this study agree that the value of audit is attributable to the quality of the audit process, mainly for being conducted in a professional manner involving fair judgements by a trustworthy person. A number of auditors also points out that audit adds credibility to the financial statements for the purpose of tax submission to the Inland Revenue Board and for loan applications to the financial institutions (Lee and Ali, 2008).

Another important issue that needs to be considered is the costs of an audit. Salleh et. al. (2008) figure out that the cost of audit is still low for the small companies and thus not considered as a burden for the companies in Malaysia. Furthermore, Collis (2005) finds that directors are willing to bear the cost of the audit once they believe about the specific advantages of annual audit to the company and the role the audited accounts play in supporting agency relationship where there is information asymmetry.

However, there are studies which find that auditing service has become a burden to some who cannot sustain its costs (Arrey and David, 2008). It is claimed that the conventional audit is an expensive anachronism for small family companies (Cox, 1992). There are views that the values and usefulness of preparing and keeping accounts under accounting standards might be insignificant compared to its costs (Corporate Law Reform Committee, 2004). More and more rigorous rules extend audit procedures which will cause higher audit costs for clients (Cox, 1992). Izma (2011)

further claims that most clients regard audit purely as a compliance exercise. To private companies, tax, dividend and compensation policies are more important than reducing information asymmetry through audit (Ittonen, 2010). Lee and Ali (2008) find that most audit clients think audit function is a non-value added activity and perceive it to be a costly process (Lee and Ali, 2008), especially to small companies. Smaller companies perceive the mandatory audit as a waste of resources and a financial burden as they think the users do not benefit from the audited financial statements (Chung and Narasimhan, 2001). Survival and maximising profits are the main concerns of the business owners, and they will strongly resist the demand to increase audit fees for audit services (Cox, 1992). Furthermore, the demand for audit is less applicable in small companies because the costs of taking the necessary legal action to sue the auditors may be proportionally higher than for the financial losses actually suffered by the users (Seow, 2001).

Research Method

The data for the study is collected using primary source. Questionnaires are distributed to 100 small and medium enterprises throughout Malaysia. However, only 62 questionnaires are returned and usable for the purpose of the study. The questionnaire attempts to examine the SMEs owners perception of the value of audit to their businesses. The questionnaire used in this study is adopted from Collis (2005) and Fadzly and Ahmad (2003). In addition, five SME owners are randomly selected for the interview to better understand the issue under study.

Data is checked for normality, reliability, validity and multicollinearity. Regression analysis is employed to analyse the data. The regression model used in the study is as follows:

$$DVAUD = \beta_0 + \beta_1 MO + \beta_2 FS + \beta_3 QI + \beta_4 CNVA + \beta_5 LAVT + \beta_6 MFR + e$$

where:

DVAUD = demand for voluntary audit by either a sole proprietor or a partner
MO = managerial ownership (Total percentage of shares held by managers);

- FS = firm size(total number of employees in a business entity);
QI = a sole trader's/ a partner's perception that audit improves the quality of information for business;
CNVA = a sole trader's or a partner's perception that audit is costly and non-value added;
LAVT = level of business activities and volume of transactions;
MFR = a sole trader's or a partner's perception that audit improves monitoring and financial reporting.
 ε = Error term

The dependent variable is the demand for voluntary audit by SMEs in Malaysia and the independent variables are the SME characteristics (MO and FS) and SME owners' perception towards audit (QI, CNVA, LAVT, and MFR).

Results and Discussions

The data is cleaned, checked for reliability, validity, non-response bias, normality and multicollinearity before the regression analysis is carried out. The value of the Cronbach's Alpha is 0.771, and the value of the Kaiser-Meyer-Olkin Measure of Sampling Adequacy is 0.51. The non-response bias test also indicates that there is no difference between those who returned the questionnaire earlier and those who sent later.

Descriptive Statistics

About 62 respondents participate in the survey, where 46 respondents are owners / partners, whereas 16 are managers who do not have any shares in the business. About 66% of the respondents are male and 34% are female.

Out of the 62 businesses, about 60% are sole proprietorships and 40% are partnership. About 22 out of 62 business entities are located in urban areas such as Klang and Kuala Lumpur and another 17 businesses are situated in suburban areas such as Jeli, Tenom and Banting. The total assets in 37 of the

businesses are more than MYR10,000, and those in 25 businesses are worth less than or equal to MYR10,000. Owners or managers in 34 enterprises employ one to four full-time employees to run the business, followed by those in 18 enterprises who operate their business with 5 to 19 full-time workers. One business entity employs more than 20 full-time employees. 9 businesses do not have any full-time employees except owner-managers. Out of 62 business entities, 50 percent of the businesses have their financial statements audited whereas the other 50 percent do not. In addition, 56% of the businesses think that they do not need audit in the future, while another 44% would consider adopting audit for their businesses in future.

Table 1 provides information about the descriptive statistics of the variables used in the study. As shown in this table, the value of skewness and kurtosis is between ± 3.0 (Gaur and Gaur, 2009, pp. 40)., thus the data is assumed to be normally distributed.

Table 1: Descriptive Statistics of Variables

	Mean	Median	Mode	Std. Deviation	Skewness	Kurtosis
MO	0.8113	1.0000	1.00	0.33625	0.355	1.33
FS	0.5283	0.4771	0.30	0.37838	0.912	1.57
QI	3.6948	3.6923	3.85 ^a	0.51554	0.340	0.097
CNVA	3.4435	3.4286	2.93 ^a	0.55300	0.038	-0.514
LAVT	3.2512	3.2857	3.71	0.61930	-0.687	0.956
MFR	3.5945	3.5714	3.43 ^a	0.56269	-0.824	2.390
DVAUD	2.6183	2.6667	2.67	0.64188	-0.042	-0.150

Table 2 presents the pairwise correlation coefficient of all the variables used in the study. The result indicates that there is no multicollinearity problem, as the correlations are below the threshold value of 0.8 (Gujarati, 2003, p. 359).

Table 2: Pearson Correlations of the Variables

	DVAUD	MO	FS	QI	CNVA	LAVT	MFR
DVAUD	1.000						
MO	-.370***	1.000					
FS	.314***	-.350***	1.000				
QI	.472***	-.162*	.072	1.000			
CNVA	-.603***	.119*	-.005	-.383***	1.000		
LAVT	.171*	.072	.038	.142*	-.062	1.000	
MFR	.102	-.159*	-.001	.337***	-.100	.183**	1.000

*Correlation is significant at 0.10 level (2- tailed)
 **Correlation is significant at 0.05 level (2-tailed)
 ***Correlation is significant at 0.01 level (2-tailed)

Regression Analysis

Table 3 presents the regression result. The result in Table 3 indicates that the adjusted R square for the model used in the study is 0.513 and the F-value is 10.126 ($p < 0.000$). It means that about 51% of the variation in the demand for voluntary audit by small businesses can be explained by the model.

Column 3 of Table 3 indicates that four of the independent variables, MO, FS, QI and CNVA are significant. However, another two independent variables (LAVT and MFR) are not significant.

Table 3: Regression Analysis

	Coefficients	T-stat
Constant	3.496	4.199***
Managerial ownership (MO)	-0.423	-2.083**
Firm size (FS)	0.359	2.028**
Improve quality of information (QI)	0.299	2.219**
Costly and non-value added (CNVA)	-0.552	-4.579***
Level of business activities /volume transactions (LAVT)	0.128	1.299
Improve monitoring and reporting(MFR)	-0.097	-0.845
R ² : 0.569	F : 10.126	
Adjusted R Square : 0.513	Significant : 0.000	

Managerial ownership (MO) is one of the significant variables in Table 3. This result suggests that when the total percentage of shares of managers

increases, the demand for voluntary audit will decrease. This result is consistent with the previous studies by Chow (1982) and Tauringana and Clarke (2000). This result is also supported by the interviews which are conducted in this study. Two sole-traders (Mr.Laundry and Ms. Bakery) and a partner (Ms.Grocery), who are interviewed claim that they prepare, manage and check the accounts themselves. Thus, they do not see the need to conduct an audit. However, another sole-trader, Mr Transportation is in the opinion that, "A partnership firm should adopt voluntary audit because the auditor from the outside party is more independent and fair to examine the accounts. Big companies which consist of many shareholders should be audited". This finding is consistent with an earlier notion that the auditor is an independent outside party who can help to check the accounts on behalf of the shareholders as more stakeholders/ partners are involved. This can help to increase the credibility of the accounts.

Another significant variable is firm size (FS). The result appears to suggest that the larger the firm size the higher the demand for audit. This is supported by the findings from the interviewees who view the firm size factor as important. A partner claims that "Big firms with more than two branches, expensive inventories, and high inventory turnover need to demand for audit". In addition, the findings from the interviews are also consistent with the finding by Collis (2005) where firm size is a proxy for cost in the cost-and-benefit analysis for auditing demand. Adverse moral selection in the agency theory explains these owner's views. The separation of ownership increases agency costs to monitor agents (Jensen et. al., 1976). When the need for information symmetry increases, demand for voluntary audit increases, and vice versa in small companies, such as in these SMEs. A sole trader, Mr Transport claims that "Small firms that experience losses do not need voluntary audit. Having suffered from losses, mandatory audit adds on burden to those firms". Another sole trader, Mr Trading expresses his view that small companies should be exempted from audit to promote their growth and development. And, Mr Laundry posits that, "I will not demand audit in the future unless my business grows and have better performance".

The perceived advantage of audit to improve the quality of information for businesses (QI) is a significant factor in the regression model. This variable has significant positive relationship with the demand for voluntary audit. The statement "Audit improves the credibility of financial information" in

the questionnaire has the highest loading which is 0.777. The results from the interview also support this result. A partner, Ms Grocery claims that,

“In the course of audit, accounts with accurate figures are produced. Then I will know my firm’s financial position, for example, the level of inventories. Audit helps owners to manage and control their business performance”.

This is supported by Mr Trading who states that:

“The accounts are expressed in true and fair view. With audited accounts, shareholders are confident to make investment in the firms. Audit provides assurance for shareholders” Owners without any financial knowledge are forced to depend solely on the accountant employed, and this opens a door for the accountant to commit fraud. Auditors with sound financial knowledge can detect the mistakes and problems in the financial statements, so the audited accounts are more accurate and reliable. With audit, the information about assets, capital and organisational goals are transparent enough to reduce the chance of corruption.”

Another sole trader, Ms Bakery posits that,

“Profit margin can be used as an effective financial measure. I can plan and target my business for the next coming year. I am interested to do business, but have no sense to manage accounts. Valuation, such as depreciation rate, through experts’ experience is more appropriate. An individual businessman does not know the current market condition”.

The perception of owners or managers that audit is costly and non-value added (CNVA) is highly significant and relates negatively with demand for voluntary audit. This finding is also supported by the interview results. A sole trader, Mr Trading claims that “Cost and benefit of audit rely on audit quality”. This is further supported by Ms Bakery:

“Audit is expensive. As I know, audit fees are MYR2,000 to MYR3,000. The businesses in the whole row of my shop will not

demand voluntary audit. The concern also arises when the internal information of businesses may be exposed to external parties. The recipes of my cakes may be disclosed”

Furthermore, some interviewees perceive that audit is troublesome.

“Audit does have its value, but is also troublesome. Owner-managers in peak audit period have to rush preparing accounts for auditors” Sometimes, the audit processes affect the operations and delay the progress of the business” [Mr. Transportation].

“Auditors may require me to close my shop for the sake of stocktaking. However, the total inventories in my business are just around 10 items. If there is software for self-audit, my business will demand audit” [Ms Bakery].

“Audit exemption can reduce the burden of small companies. Small companies can save costs and time through shortening the process on paper works. So, the management can focus on the core businesses” [Mr. Trading].

Conclusion

Overall, the result indicates that the owners of small businesses would demand for voluntary audit depending on the costs and benefits of the audit exercise to their businesses. Among others, the results appear to suggest that the firm size, managerial ownership and perceptions of the managers would influence their demand for voluntary audit.

However, the conclusions drawn from this study should be interpreted in a limited way, which would potentially represent opportunities for further investigation in future research. Firstly, the samples which are used in this study are quite small, future research can include more samples to represent Malaysian SMEs. In addition, this study only considers six independent variables. There are many other independent variables which may influence the demand for voluntary audit not mentioned in this study. Future study may include other variables which may influence this relationship.

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