



THE IMPACT OF FRS ADOPTION ON AUDIT FEES:
EMPIRICAL EVIDENCE FROM MALAYSIAN
LISTED COMPANIES

BY

WAN ABDUL WAHID BIN WAN LOKMAN

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Kulliyyah of Economics and Management Sciences
International Islamic University
Malaysia

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ABSTRACT

The purpose of this study is to examine the association between FRS adoption and audit fees paid to external auditors in Malaysia. Specifically, it is argued that the new accounting standards, FRS, are perceived to be substantially different from the old standards, which are more complicated and thus require auditors to undertake greater audit efforts, which, in turn, lead to higher fees charged to clients. Furthermore, it is also hypothesised that higher audit fees are expected to be stronger for companies that adopt FRS, as these companies are perceived to have higher risks. This, in turn, results in higher fees being paid to the external auditors. The data for the study is obtained from secondary data (annual report). The sample companies are 170 companies listed on Bursa Malaysia for the financial year ended 2006. Based on 170 sample-firms, the results reveal that FRS adoption is positively and significantly associated with statutory audit fees. The results are consistent with FRS adoption, which will result in increased scope of work and responsibility of the external auditors, and, ultimately, entails additional costs. The findings of this study in Malaysia offer support for previous finding concerning the complexity of FRS and the lack of preparation in adoption among Malaysian companies. However, there is no evidence to support that non-audit fees are positively and significantly associated with FRS adoption. This study contributes to the audit fees literature by examining the association between FRS adoption and fees paid to external auditors. In particular, instead of using a longitudinal study, this study focuses on the first year FRS adoption. Furthermore, this study is conducted in Malaysia, which is a unique environment that offers a different development towards IFRS adoption whereby the MASB is gradually and progressively improving the accounting standards towards full IFRS adoption in 2012.

ملخص البحث

والغرض من هذه الدراسة دراسة الرابطة بين اعتماد FRS ومراجعة الرسوم المدفوعة للمراجعة الخارجية للحسابات في ماليزيا. ويقال على وجه التحديد أن المعايير المحاسبية الجديدة، يعتبر FRS يكون الاختلاف الكبير من المعايير القديمة، أكثر تعقيداً ومن ثم تتطلب مراجعي الحسابات بذل المزيد من الجهود لمراجعة الحسابات، الذي يؤدي بدوره إلى ارتفاع الرسوم باتهام للعملاء. وعلاوة على ذلك، هو ركازات أيضا أن أعلى أتعاب المراجعة من المتوقع أن تكون أقوى للشركات التي تعتمد FRS ما يجري ينظر هذه الشركات على أن يكون مستوى أعلى من المخاطر. هذه نتائج دورة في ارتفاع الرسوم المدفوعة لمراجعي الحسابات الخارجيين. يتم الحصول على البيانات الخاصة بهذه الدراسة من بيانات ثانوية (التقرير السنوي). شركات العينة هي 170 الشركات المدرجة في بورصة ماليزيا للسنة المالية المنتهية في عام 2006. وتكشف النتائج استناداً إلى عينة 170-الشركات، أن اعتماد FRS يرتبط ارتباطاً إيجابياً وبشكل كبير مع أتعاب المراجعة القانونية. النتائج تتسق مع FRS اعتماد سيؤدي إلى زيادة نطاق عمل ومسؤولية المراجعين الخارجيين للحسابات، الذي ينطوي على تكاليف إضافية وأخيراً. النتائج التي توصلت إليها هذه الدراسة في ماليزيا تقديم الدعم للحقائق السابقة في تعقيد FRS وعدم الاستعداد في التنبؤ فيما بين الشركات الماليزية. ومع ذلك، لا يوجد دليل لدعم أن الرسوم غير المراجعة ترتبط إيجابياً وبشكل كبير مع اعتماد FRS. هذه الدراسة يساهم في الأدب أتعاب مراجعة الحسابات من خلال دراسة الرابطة بين اعتماد FRS والرسوم المدفوعة لمراجعي الحسابات الخارجيين. على وجه الخصوص، بدلاً من استخدام دراسة طويلة، تركز هذه الدراسة على اعتماد FRS السنة الأولى. وعلاوة على ذلك، أن هذه الدراسة تجري في ماليزيا، وهي بيئة فريدة من نوعها يقدم تطوراً مختلفاً نحو اعتماد معايير الإبلاغ المالي الدولية، حيث مناسب تدريجياً وتدرجياً تحسين معايير المحاسبة نحو اعتماد المعايير الدولية الكاملة في عام 2012.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

.....
Hafiz Majdi Ab. Rashid
Supervisor

.....
Hairul Azlan Annuar
Co-Supervisor

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

.....
Sherliza Puat Nelson
Examiner

This dissertation was submitted to the Department of Accounting and is accepted as a fulfilment of the requirement for the degree of Master of Science in Accounting.

.....
Suhaiza Ismail
Head, Department of Accounting

This dissertation was submitted to the Kulliyah of Economics and Management Sciences and is accepted as a fulfilment of the requirement for the degree of Master of Science in Accounting.

.....
Khaliq Ahmad
Dean, Kulliyah of Economics and
Management Sciences

DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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Signature.....

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EVIDENCE FROM MALAYSIAN LISTED COMPANIES**

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LIST OF ABBREVIATIONS

ACCA	Association of Chartered Certified Accountants
FRS	Financial Reporting Standards
GAAP	Generally Accepted Accounting Principles
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IFRS	International Financial Reporting Standards
LA	Licensed Accountant
MASB	Malaysian Accounting Standards Board
MFRS	Malaysian Financial Reporting Standards
MIA	Malaysian Institute of Accountants
MICPA	Malaysian Institute of Certified Public Accountants
ROA	Return on Asset
SC	Securities Commission
SOX	Sarbanes-Oxley Act of 2002

CHAPTER 1

INTRODUCTION

1.0 INTRODUCTION

This chapter serves as the introductory chapter for the study. This first section starts with the background of the study, followed by the problem statement, objectives of the study and research questions. The next section discusses the motivation of the study, significance of the study, and, finally, the chapter concludes with a presentation of the organisation of the study and summary.

1.1 BACKGROUND OF THE STUDY

In conjunction with the growth of cross border trading and market globalisation, the introduction of the single International Financial Reporting Standards (IFRS) is to overcome differences in accounting practices around the world and to eliminate the unnecessary barriers for economic growth at the global level. The transition to a single accounting standard has been regarded as a major concern and challenge to some countries. Complexity and unfamiliarity with the IFRS have attracted the attention of the preparers of financial statements, academicians, regulators and auditors. As the core characteristic of the IFRS is fair value, there has been serious debate and discussion, especially concerning the measurement of the fair value whereby the preparers are expected to use high professional judgment in compliance with the IFRS. Another idea pertaining to the introduction of the IFRS is to incorporate the principle-based accounting standards. These new accounting standards only have a simple set of principles, which is set out to ensure that financial reporting activities

produce good financial statements. These principle-based accounting standards require high professional judgment and decisions in applying the accounting policies and treatments as stipulated in the accounting standards. Thus, it often requires more time for preparers to assess proper accounting treatment on a firm's transactions, balances and estimates due to the lack of specific rules and treatments under principle-based accounting standards. In addition, the adoption of the IFRS may also increase the complexity of the financial reporting process. This complexity may sometimes result in a conflict of opinion, especially among preparers, regulators and auditors. The opportunity for management misreporting the companies transaction, balances and estimates will be increased in the event that preparers and auditors do not have enough expertise in the field of these new principle-based accounting standards.

In Malaysia, the Malaysian Accounting Standards Board (MASB) issued 21 new accounting standards in 2005, which are known as Financial Reporting Standards (FRS). These accounting standards have been made effective for all Malaysian non-private entities commencing 1 January 2006. The issuance of the new accounting standards is intended to align the Malaysian accounting standards with the global accounting standards, namely IFRS. The new standards, with a few exceptions, are substantially in line with the International Financial Reporting Standards (IFRS) and the International Accounting Standards (IAS). The IAS is a series of accounting standards that were published by the International Accounting Standards Committee (IASC) between 1973 and 2000. After the establishment of the International Accounting Standards Board (IASB), all the newly published accounting standards from 2001 have been renamed as IFRS. The Malaysian FRSs have been renamed concurrently with the name of the IFRS and the IAS. For example, IFRS 1, First-time Adoption of International Financial reporting Standards is known as FRS 1, First-time

Adoption of Financial Reporting Standards, and IAS 8, Accounting Policies, Changes in Estimates and Errors is known as FRS 108, Accounting Policies, Changes in Estimates and Errors. In short, the FRS number is the same as the actual IFRS series and hundred-series for standards that is originally from IAS for example IAS 11 is known as FRS 111 and IAS 7 is known as FRS 107. However, there are a series of the IFRS standards that supersede the IAS, for example, FRS 114, Segmental Reporting was superseded by FRS 8 with effect from 1 July 2009. There are also locally developed standards, which are not equivalent to international standards, such as FRS201; the MASB prefix FRS number 200 series for locally developed standards.

The MASB has made mandatory the adoption of the issued and effective FRS for all companies that are non-private entities. However, private entities are encouraged to adopt FRS. A private entity is a private company, which is incorporated under the Companies Act 1965 and complies with the next two conditions. First, this entity is not required to prepare and lodge any financial statements under any law administered by the Securities Commission (SC) and Bank Negara Malaysia (BNM). Second, it is not the subsidiary, associate or any jointly controlled entity that is required to lodge any financial statements under the law administered by the SC and BNM. The adoption of FRS must be made in full compliance with the issued and effective FRS. The firms are not allowed to revert to the old MASB standards once they have applied the FRS. Hence, this compulsory adoption of the FRS has been regarded as a major challenge for all Malaysian entities other than private entities, especially listed companies. No transition period has been given for the adoption of the FRS unlike the accounting standard boards of other countries, which are adopting the IFRS, for example, New Zealand had a 2-year transition period from 2005 to 2006 (Griffin, Lont and Sun, 2009). Malaysian firms are required to comply with these new

accounting standards within the short time frame given by the MASB, that is, by 2005. However, firms whose financial year-end is other than 31 December will have a one year transition period. Those firms whose financial year-end is 31 December will be compulsorily required to adopt the FRS commencing 1 January 2006. In these principle-based accounting standards, which lack clear accounting treatment and rules, the accountants or preparers of the financial statements must spend more time, effort and resources in identifying and analysing the business transactions, balances and estimates under the IFRS/FRS regime in order to make the most appropriate judgments and decisions to ensure that compliance with the IFRS/FRS is adequate (Marden and Brackney, 2009).

Similarly, the audit firms must also allow the auditors to participate in professional courses, training and workshops with regard to the FRS implementation. In order to provide the best quality of audit service to their clients, the audit firms also have to invest in upgrading and enhancing the resources and technology used, for example, providing specific training to the auditors relating to the FRS. Knowledge is the key point in providing a quality audit service. Furthermore, in the field of audit work, the auditors have to spend more time and effort in auditing the financial statements to ensure compliance with FRS. With respect to the clients' preparation and education relating to the FRS implementation, the higher possibility of misreporting will lead to higher audit work, which will increase the audit cost to the audit firms. In order to compensate for the increase in the audit cost, auditors might pass the incremental cost to the clients in terms of statutory audit fees and non-audit fees. Therefore, in addition to the benefit of the adoption of the FRS, there might be a possible unrevealed cost associated with this adoption, especially statutory audit fees and non-audit fees. The FRS adoption in Malaysia is considered as one of the most

important events among all Malaysian companies, especially non-private entities. The study on the FRS adoption could be an interesting and important topic for audit market research.

Since the pioneer study on audit fees by Simunic (1980), audit fee research has been increasingly conducted by researchers around the world. Some of the literature suggests that audit fees could be a proxy for the study of audit quality (O'Sullivan, 2000; Salleh, Steward and Manson, 2006; Mitra, Hossain and Deis, 2007; Bliss, Gul and Majid, 2011), agency cost (Mustapha and Che-Ahmad, 2011; Griffin, Lont and Sun, 2010) and auditor independence (Ghosh, Kallapur and Moon, 2009). The variation of statutory audit fees and non-audit fees paid to external auditors may also be explained by the changes in regulatory requirements. This is due to the interrelation of the audit services and certain regulations. The Companies Act 1965 requires that all financial statements of Malaysian companies be audited by an independent auditor on an annual basis. The Companies Act 1965 also requires companies to comply with approved accounting standards in Malaysia. Thus, it is assumed that audit fees will be varied as there is a new development in the regulatory requirements, such as the introduction of the new accounting standards and certain other regulations that directly affect the audit services. In view of these important changes and developments in the regulatory requirements, some prior studies focused on the impact of the regulatory requirements on audit fees like the Sarbanes-Oxley Act (e.g. Asthana, Balsam and Kim, 2009; Chi, 2010; Foster, Ornstein and Shastri, 2007; Ebrahim, 2010; Salman and Carson, 2009) and financial accounting standards (Griffin, Lont and Sun, 2009; Vieru and Schadewitz, 2010; and Lin and Yen, 2010; Yaacob and Che-Ahmad, 2012). Among the reasons for focusing on audit fees could be their influence on the agency cost and independence, which are ultimately related

to the audit quality and financial reporting quality. Since the topic of audit fees has attracted the interest of many researchers, it highlights the importance of the subject. Many prior studies attempted to investigate the rationale and factors that explain the variation of the audit fees paid to external auditors. The audit fee issue might have become more interesting following the collapse of a multinational audit firm some years ago and the implementation of the Sarbanes-Oxley Act 2002, which is mainly related to the issue of auditor independence. Prior studies find that the audit fees increased after the implementation of the Sarbanes-Oxley Act 2002 (Salman and Carson, 2009; Ebrahim, 2010) because of the increase in the amount of audit effort and time.

Similarly, prior studies also find that the changes in other requirements, which are directly related to the financial reporting process, for example financial reporting standards, might also lead to an increase in the audit fees (e.g. Griffin et al., 2009; Vieru and Schadewitz, 2010; Lin and Yen, 2010; Yaacob and Che-Ahmad, 2012). Changes in the financial reporting process might increase the risk of client mismanagement in the financial reporting process, which may increase the litigation risk of the auditor. Therefore, this can increase the audit risk in that this situation may force the auditor to exert more effort, increase resources and perform more substantive work. The litigation risk might drive auditors to increase their work and effort to reduce the audit risk.

The Malaysian FRSs are set based on the principle based standards, which require the preparers of financial statements to perform more subjective interpretation. The preparers might need to seek help from other parties, such as auditors, for guidance on and an illustrative implementation of the FRS in order to discharge their duties towards shareholders (Tan, Lazar and Othman, 2007). Despite providing

statutory audit services, the auditor might also have the opportunity to render non-audit services to their clients with regard to the introduction of these new accounting standards. In Malaysia, the auditors are free to provide a consultancy service to their clients so long as it does not breach the practice guides, as issued by the Malaysian Institute of Accountants (MIA), which are strictly formed to maintain the independence of the external auditors from the clients. Because of the auditor's expertise in compliance with financial reporting standards, the auditor may be a good consultant to the preparers in handling the complexity of the FRS. Despite an increase in statutory audit fees, the adoption of the FRS might also lead to an increase in the non-audit fees to be paid to the auditors.

With regard to the above facts and findings, this study attempts to investigate the impact of the FRS adoption on statutory audit fees and non-audit fees paid to the external auditors for Malaysian listed companies. This study could extend the audit fees study on the impact of the mandatory IFRS adoption on statutory audit fees and non-audit fees based on the Malaysian perspective.

1.2 THE PROBLEM STATEMENT

Following the corporate scandals some years ago, the financial reporting and auditing profession was adversely affected, which prompted some countries to place the blame for these scandals on the weakness of governance and financial reporting (Griffin et al., 2009). Some initiatives were initiated at a global level to overcome such bad perception concerning the accounting and auditing profession, for example, enforcement of the Sarbanes-Oxley Act of 2002 (SOX) and International Financial Accounting Standards (IFRS), which are to improve the corporate governance, audit quality, auditor independence and financial reporting environments.

The introduction of the IFRS has received some attention from both practitioners and academicians. As discussed above, the adoption of the IFRS requires some important ingredients for the success of the implementation of the IFRS. The nature and basis used by the IFRS are significantly different to the local accounting standards. As such, some of the important factors that affect the quality of the financial reporting and success of the IFRS adoption are auditor independence, training and compensation. The expectation on the auditors in providing quality services has attracted the attention of many people, especially in auditing financial statements to ensure their compliance with IFRS. It is noted that the objective of the IFRS compliance is fair presentation for both the preparers and the users of the financial statements. Therefore, the users of financial statements may expect to rely on the audited IFRS compliant financial statements to make decisions concerning their investments, financing or operation of the companies. As such, in achieving such expectations, the auditors might invest more in improving and upgrading the audit services given to their clients. These activities might be followed by the increase in the cost to the auditors. The increase in audit cost will be systematically transferred to their clients by way of statutory audit fees or non-audit fees. Another aspect that auditors might address in achieving the expectations of the people is to ensure that their audit risk is mitigated as much as possible to avoid any legal liabilities against them. This situation might also affect the increase in audit fees because the auditors have to spend more time, effort and resources to mitigate the audit risk.

As such, the adoption of the IFRS might increase the fees paid to the external auditors. This is consistent with the findings of prior studies on the adoption of the IFRS whereby there is an increase in the auditing cost after the adoption of the IFRS (Marden and Brackney, 2009). Notwithstanding the important impact of the IFRS

adoption on the audit market, there are limited studies on the effect of IFRS adoption on audit fees in different countries. Currently, there are limited studies on the impact of the adoption of the IFRS on audit fees around the world, for example, New Zealand (Griffin et al., 2009), Finland (Vieru and Schadewitz, 2010), China (Lin and Yen, 2010) and Malaysia (Yaacob and Che-Ahmad, 2012).

This study investigates the impact of the first time adoption of the FRS on statutory audit fees and non-audit fees among Malaysian listed companies. The sample companies are from 2006, which is the first year of mandatory adoption of the FRS. The statutory audit fees and non-audit fees are most likely affected by this first time adoption. The study on statutory audit fees and non-audit fees with respect to the adoption of the FRS may attract some researchers' views, especially regarding the cost structure of the audit firm, predicting future fees and investigating the audit firm pricing policies.

1.3 OBJECTIVES OF THE STUDY

The main purpose of the study is to investigate whether there is any relationship between the FRS adoption and the statutory audit fees and non-audit fees paid to the external auditors for Malaysian listed companies. This study will analyse the annual reports of companies in order to achieve the objective. This study will select the annual reports for 2006 and collect the necessary data from the sample companies. From this main purpose, the following detailed research objectives are developed:

RO: To investigate the possible relationship between FRS adoption and statutory audit fees paid to external auditors during the first year of the mandatory adoption of FRS in the context of Malaysian listed companies.

RO: To investigate the possible relationship between FRS adoption and non-audit fees paid to external auditors during the first year of the mandatory adoption of FRS in the context of Malaysian listed companies.

1.4 RESEARCH QUESTIONS

The research questions for this study are motivated by the introduction of the implementation of FRS in 2006, which is a significant development for the Malaysian financial reporting process towards the implementation of the full IFRS in 2012. Since the focus of this study is the impact of FRS adoption on audit fees, this study will be guided by the agency theory, which is used as the framework for explaining the impact of the FRS adoption on the statutory audit fees and non-audit fees. The agency theory focuses on the relationship between the principal and the agent – shareholder and company’s management. The agency theory defines a company as a “nexus of contracts” that involves two parties – the principal, who supplies the capital, and the agent, who manages the day-to-day affairs of the company (Jensen and Meckling, 1976). The management as an agent has certain obligations, which they have to perform in order to comply with the terms and conditions of the contract, which is mainly designed to maximise the principal’s values by virtue of the economic contract. One of the important concepts in the relationship between the principal and the agent is the selection of the appropriate governance mechanism. It is understood that there is a possible conflict of interest between the agent and the principal. Thus, the appropriate governance mechanism is needed to ensure an efficient alignment of the interests of the principal and the agent. Compliance with approved accounting standards could be controlled via the appropriate governance mechanism. The external auditors serve as the moderator in the principal-agent relationship. Thus, the impact of

the new accounting standards on the workload and effort of the external auditors will directly affect the agency cost. The agency theory would be an appropriate framework to demonstrate and explain the impact of FRS adoption on the statutory audit fees and non-audit fees during the first year of mandatory adoption of the FRS in 2006, which is a significant and important event for Malaysian companies, especially for non-private entities including listed companies.

This study addresses two research questions as follows:

RQ: Is there any significant relationship between FRS adoption and statutory audit fees paid to external auditors during the first year of the mandatory adoption of FRS?

RQ: Is there any significant relationship between FRS adoption and non-audit fees paid to external auditors during the first year of the mandatory adoption of FRS?

1.5 SIGNIFICANCE OF THE STUDY

This study focuses on the ongoing topic, which could be of special interest to the accounting literature. First, this study investigates the impact of FRS adoption on the statutory audit fees and non-audit fees in the Malaysian listed companies. There are limited studies investigating the impact of FRS adoption on fees paid to external auditors for Malaysian listed companies. This study could extend the current study on the impact of the adoption of FRS on both statutory audit fees and non-audit fees for Malaysian listed companies during the first year of FRS adoption. Malaysia is chosen as the location for this study due to its background as a developing country and its contribution to the development of the world economy in certain sectors.

Second, the findings of this study will be able to highlight some FRS adoption issues, for example, its impact on statutory audit fees and non-audit fees, for the

accounting standard setters and accounting associations, such as the Malaysian Institute of Accountants (MIA), Malaysian Institute of Certified Public Accountants (MICPA) and Malaysian Accounting Standards Board (MASB). These findings could highlight the audit service pricing policies to the accounting regulators, especially with regard to the changes in the accounting standards.

Finally, the empirical evidence gathered from this study is expected to complement the existing literature on the audit market. There is considerable literature that explains and examines the variation of audit fees paid to external auditors. This study's findings could contribute to the research on audit fees in terms of explaining the variation of audit fees paid to the external auditor in the event of a change in the regulatory requirements of the accounting standards. Overall, the research might support the worldwide research on the issue of audit fees with specific reference to the Malaysian perspective.

1.6 MOTIVATION FOR THE STUDY

This study is motivated by two gaps in the present literature. First, the extant prior studies relating to the adoption of FRS in Malaysia focus heavily on the preparation of the first time adoption (e.g. Tan et al., 2007), the impact of FRS adoption on audit delay (e.g. Yaacob and Che-Ahmad, 2012a) and the compliance issue (e.g. Carlin, Finch and Laili, 2009). There is limited focus on other aspects relating to the adoption of FRS, for example, the impact of FRS adoption on statutory audit fees and non-audit fees paid to external auditors. Second, there is insufficient literature in the area concerning the impact of changes in the accounting standards on the statutory audit fees and non-audit fees in developing countries, including Malaysia. Yaacob and Che-Ahmad. (2012) focus on the FRS adoption in Malaysia in respect of the total fees paid

to external auditors. There is limited study on the impact of FRS adoption specific to both statutory audit fees and non-audit fees. To the best of the researcher's knowledge, this study could be considered as a first research, which investigates the impact of FRS adoption on statutory audit fees and non-audit fees in Malaysia.

This study is also motivated by the introduction of FRS implementation in 2006. The MASB has taken the initiative to make compulsory the adoption of FRS in 2006 as a stepping stone to adopting the full IFRS, which is targeted for 2012. Prior studies find that the adoption of IFRS impacts on the audit fees. Therefore, this study investigates the impact of FRS adoption on statutory audit fees and non-audit fees in the first year of the mandatory FRS adoption based on the Malaysian perspective.

1.7 ORGANIZATION OF CHAPTERS

The contents of this research are organized into six chapters. This section discusses the contents of the research.

Chapter One: Introduction: This chapter presents a brief discussion of the background of the study, statement of the problem, research questions, general purpose and specific objectives of the study, motivation for the research and significance of the study.

Chapter Two: Literature Review: This chapter provides an extensive review of prior literatures pertaining to the factors that influence audit fees. The researcher will specifically focus on past studies undertaken in the context of the changes in regulatory requirements as the current study is being conducted. The researcher will also conduct a review of the literature pertaining to developed and developing countries.