

*Review Article*

**Exemption of Annual Audit for Small Companies: A Review**

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**ABSTRACT**

In Malaysia, all companies are required to have their accounts audited. However, the application of this mandatory requirement on small companies is currently under review, and the issue is whether audit firms could survive should voluntary audit be implemented. Salleh *et al.* (2008) surveyed the perception of small audit firms on this issue. Most of the respondents perceived that the benefits derived from statutory audit outweighed its costs, and thus, mandatory audit should be retained. Nonetheless, the views of other stakeholders of statutory audits are also pertinent. This paper reviews the previous research on the issue of voluntary audit in Malaysia and other countries, some of which surveyed the perceptions of the directors and management of small companies. These studies revealed that companies which perceived that they would benefit from the audit would continue to have their accounts audited. Thus, clients of audit firms which produced quality audit work might continue to have their accounts audited, and such audit firms, immaterial of their sizes, could survive even if audits for small companies were made voluntary.

**Keywords:** Audit benefits, audit exemptions, small companies

**INTRODUCTION**

On 17 December 2003, the Companies Commission of Malaysia established the Corporate Law Reform Committee “to undertake a fundamental review of the current legislative policies on corporate law in order to propose amendments that are necessary for corporate and business activities to function in a cost effective, consistent, transparent and competitive business environment, in line with international standards of good corporate” (Suruhanjaya Syarikat Malaysia, 2010). Among the studies undertaken was a review on the requirement of mandatory audit for all companies. In early 2009, the Corporate Law Reform Committee issued a recommendation to retain mandatory audit for all

companies, but power be given to the regulator to exempt small companies from this requirement (SSM, 2009). If audit was deregulated, audit firms which concentrated on audit work for small companies would be affected.

The article by Salleh, Che Rose, Kumar and Jaafar on “Auditors’ Perceptions on Obliteration of Mandatory Annual Audit: An Empirical Study” in 2008 is timely, for it explored the perceptions of auditors on the requirement of mandatory audit on small companies and their readiness in the event Malaysia decides to follow the footsteps of other common law countries to exempt such companies. The paper by Salleh *et al.* (2008) is the first known published article that examined the perceptions of auditors on this

issue in Malaysia. However, as noted by Salleh *et al.*, the article is not without its limitations.

In this paper, the writer examines the issue of deregulation of audit for small companies by reviewing previous studies conducted both in Malaysia and other countries. As the exemption of the mandatory audit for small companies is imminent, it is vital for the audit profession to ensure small companies and their stakeholders appreciate the value and relevance of an audit. Previous studies have shown that companies which perceive audit to be beneficial are more likely to continue with it. The regulator, too, plays an important role in balancing the interests of the small companies and that of the stakeholders and enacting a win-win formula for all.

The writer shall first begin with a review of Salleh *et al.* (2008), before examining other studies conducted in Malaysia and in other countries. This is followed by the debate which is currently taking place in Malaysia, i.e. whether to deregulate audit for small companies, and suggestions for reforms by the auditors in anticipation of the deregulation.

#### **ESSENCE OF SALLEH *et al.*, (2008)**

In Malaysia, section 169 of the Companies Act 1965 requires all companies to have their annual financial accounts audited by an external auditor. It is immaterial that the company is small in economic size or is owner managed, that is, the company is managed by the shareholders themselves, and not by outsiders. The theory of agency costs has been cited as one of the reasons for the obliteration of mandatory audit for small companies in other countries. Where the company is owner managed, "it appears meaningless for an auditor to report to the shareholders that the directors (who are also the shareholders) have produced a true and fair picture of the financial statement of the business ... (Audit) is a great waste of money and resources" (Salleh *et al.*, 2008, p. 62).

The trend in other countries is to deregulate audit. The United Kingdom, Canada, Australia and Singapore no longer mandate all companies

to have their financial accounts audited. Malaysia may take a similar path. One important issue is whether the auditors in Malaysia are ready. It was observed in Salleh *et al.* (2008) that 92% of the audit firms surveyed relied on audit as their main source of income. Many might not survive if audit exemptions were to be implemented.

Salleh *et al.* (2008) also examined the perceptions of auditors and their readiness should voluntary audit be implemented in Malaysia. Salleh *et al.* mailed questionnaires to 482 auditors of small firms in Kuala Lumpur. Only 64 completed responses were received. Though the results cannot be generalized, the study is important as it is the first known study in Malaysia on the perceptions of auditors pertaining to the introduction of voluntary audit.

In Salleh *et al.* (2008), the turnover of 86% of the respondents was below RM1,000,000. The majority of the respondents' clients were small companies with paid-up capital of less than RM500,000 and with not more than 50 employees. 34.5% of the respondents indicated that 90% to 99% of their clients were from this category and 83.6% of them agreed that statutory audit was a major contribution to the firms' income. Possibly due to the concentration of audit work, most respondents were not ready to offer other services and might thus face problem in staff reallocation, if voluntary audits were introduced for small companies.

Another interesting finding in Salleh *et al.* (2008) is that the majority of the respondents felt that audit did add value to small companies (69.2%) and that the audit fees imposed were not too costly to the companies (60%). Thus, auditors perceived that the benefits derived from the statutory audit outweighed its costs. Meanwhile, 73.4% of the respondents indicated that mandatory audit for small companies should be retained, and the characteristics of these respondents were; firstly, the firms to which the respondents were attached to were small in size (68.8%); secondly, they derived a major part of their income from audit work (59.4%); and thirdly, they provided a low number of non-audit services (46.9%).

### DISCUSSION ON SALLEH *et al.* (2008)

Salleh *et al.* (2008)'s conclusion, i.e. auditors in Malaysia were generally not in favour of audit exemption, is anticipated. To auditors who handle mainly small company audit, it is only logical that they desire mandatory audit to be retained. However, if audit was to be made voluntary, they should then be concerned with the perception and intentions of their clients. Would the clients continue to demand audit after its deregulation? To predict their reaction, the results of some previous surveys on the perceptions of the small companies, as well as the characteristics of the companies which would most likely retain audit despite the exemption, would be pertinent to the auditors.

#### *Findings of Salleh et al. (2008)*

The responses from the auditors in Salleh *et al.* (2008) were consistent with the findings of ICPAS (2000) in Singapore, Chung and Narasimhan (2001) in Hong Kong, and Tabone and Baldachhino (2003) in Malta. The introduction of voluntary audit would have an adverse impact on the revenue of small audit firms which derived a major part of their income from audit work, and it is only natural for the practitioners in these small firms and their counterparts to protect their "rice bowl". Furthermore, as highlighted by Salleh *et al.* (2008, p. 62):

Malaysia being a member of WTO GATT, it is only a matter of time when services such as consultancy and advisory will also be liberalized. With the liberalization process, audit firms as well as auditors in Malaysia will face greater competition locally and globally... It is also important to ensure the local audit firms' survival among foreign accounting firms and also the non-accounting service providers such as Certified Financial Planner (CFP) and Certified Financial Analyst (CFA).

The onslaught of foreign professional accounting firms and the advent of voluntary audit for small companies may strangle the livelihood of small audit firms, particularly those which concentrate on audit work for small companies. It is submitted that the fear of the practitioners in these firms was reflected in their responses to the study by Salleh *et al.* (2008). To the statement "it is not compulsory for a small company's financial report users to have audited accounts in decision making processes", 67.2% disagreed even though it is trite that auditors have always tried to ward off liability to the third parties. Auditors always insist that they owe a duty to no one but the auditee company (Sikka *et al.*, 2009). Other users of the audited accounts and individual shareholders have no *locus standi* to sue the auditors even where the auditors were negligent in the audit. This was decided in *Caparo Industries PLC v Dickman* (1990). However, for the purpose of supporting the auditors' argument, that it is necessary to retain audit; the respondents agreed that financial report users do depend on the auditor's verification that the accounts give a true and fair view of the company's financial position.

It is only expected that the audit profession would respond to protect their self interest (Cousins *et al.*, 1999). The reaction is consistent with that displayed in ICPAS (2000) and Khairinuddin (2005). In ICPAS (2000), the Institute of Certified Public Accountants Singapore (ICPAS) carried out a survey by sending questionnaires to its members, selected small companies, and bankers to gauge their views on the issue of audit exemption. In its report, it strongly recommended that the mandatory audit requirement for all companies be retained. However, the report did not provide a detailed analysis of the responses from the respondents. This gave rise to a speculation that the ICPAS, as in other professional bodies, acted to protect the interest of their members (Sikka, 2004).

In 2005, Khairinuddin attempted to survey the members of the Malaysian Institute of Accountants, but it was abandoned due to the

feedback from his pilot study (Khairinuddin, 2005, p. 50):

Some respondents found the proposed survey threatening and would prefer the survey not to be undertaken. They opined that the small practitioners would definitely object to the implementation as their revenue was mainly derived from audit fees. In fact, 2 of the responses via letter were circulated to the rest of the small practitioners to not respond to any survey conducted on audit exemption as they viewed the outcome as predetermined and prejudicial towards small practitioners. They viewed that the audit exemption regime would eliminate the small audit practitioners.

As a result, Khairinuddin (2005) surveyed only the senior management of small companies. His study is further discussed in the next section.

It is submitted that the debate on the exemption of mandatory audit among small companies would be better appreciated if the views of other interest groups such as the small companies themselves and other users, namely the shareholders, financiers and authorities, are obtained. A review of literature from Malaysia and other countries which went through a similar experience would shed light on the effects of introducing voluntary audit.

#### *Previous Studies in Malaysia*

In Malaysia, other than Salleh *et al.* (2008), there has been no other known study conducted on the perception of auditors on audit exemption. As mentioned above, this was not due to wanting to attempt but the hindrances faced (Khairinuddin, 2005). However, there were two surveys conducted on the directors and representatives of small companies in Malaysia to obtain their views on the same topic. These were by Khairinuddin and the study commissioned by the Corporate Law Reform Committee (CLRC), both in 2005. The results of the latter were

reported and made available to the public in January 2007 (CLRC, 2007).

Khairinuddin (2005) surveyed the senior management of small companies. The researcher sent questionnaires to the senior management of 235 randomly selected companies registered with the Small and Medium Industries Development Corporation (SMIDEC). A total of 200 usable responses were received. Khairinuddin (2005) found that 41% of the respondents said that they would continue to have their companies accounts audited even if the audit was made voluntary. Only 23% disagreed. 36% were undecided. Even family owned companies strongly agreed to opt for voluntary audit. This could possibly be due to their need to outsource their accounting work, for the majority had indicated that they engaged external accountants to prepare the annual accounts (64%), as well as to provide audit services (63.5%) and tax services (59.5%).

In the subsequent study commissioned by the CLRC in 2005, questionnaires were mailed to 2300 directors of private limited companies. 407 responses were received. 71% of the respondents indicated that they would continue to have their companies' accounts audited even if the mandatory audit provisions were deleted from the Companies Act 1965. In this connection, it must be mentioned that the CLRC was established to reform the company legislation to make it current and in line with the best global practices (SSM, 2008). The CLRC study also found that 56% of the respondents perceived audit to be beneficial. Overall, the respondents seemed to find the benefits of audit to outweigh its costs (CLRC, 2007).

Thus, the findings of the CLRC (2007) are consistent with that of Khairinuddin (2005), but contrary to the general perception of the auditors surveyed by Salleh *et al.* (2008). It is submitted that the fear that many of the smaller audit firms would not survive if audit exemption was to be implemented may be unfounded, for the majority of respondents surveyed in both studies by Khairinuddin and the CLRC which had indicated that the directors and senior management of small companies would still continue to have their financial accounts audited.

### *Previous Studies and Development in Other Countries*

There are also numerous studies from other countries, which were carried out both before as well as after their respective company legislations were amended to exempt small companies from audit. Countries, which are at the crossroad to whether retain or deregulate mandatory audit such as Malaysia, may draw experience from other countries which have undergone a similar debate. This will enable them to gain a better understanding of the issue.

In the United Kingdom, a review of the statutory audit for small companies was first done in 1985. After the review exercise, the UK Government decided to retain the audit. However, this issue was raised again in 1992. It is noteworthy that the Institute of Chartered Accountants of England and Wales (ICAEW) then recommended the exemption of very small companies (Freedman & Godwin, 1993). This was probably because ICAEW knew that they would not be able to stem the tide for exemption as the costs of audit would be higher due to the implementation of the European Community's directive on auditors' qualification, resulting in the non-justification of benefits derived from the audit vis-à-vis its costs (Tauringana & Clarke, 2000; Freedman & Godwin, 2003). Furthermore, many developed commonwealth countries, such as the United States and Australia, no longer require mandatory audit for all companies regardless of their size.

Despite the protest from the Inland Revenue and bankers, the UK Government in 1994 proceeded to exempt small companies from annual audits. As anticipated by Freedman and Godwin (1993), the implementation of audit exemption led to the debate on the classification of "a small company". In more specific, what type of companies should be exempted from mandatory audit? The Government settled for the tests which were based on the size of the company's balance sheet, turnover and workforce. Throughout the years, the threshold was gradually raised to keep up with the change in economy and monetary value. For example, the maximum turnover was raised from £90,000

when audit exemption was first implemented in 1994 to £6.5 million in 2008 (Collis, 2008).

Tauringana and Clarke (2000), and Collis *et al.* (2004) studied the demand for audit exemption in the UK after the exemption was selectively implemented. They found support in the hypothesis that the size of a company correlated positively with the demand for audit. However, other variables such as the company's gearing ratio, perceived benefits derived from audit and proportion of non-family management were also significant characteristics of companies which opted for voluntary audit. In a subsequent study by Collis (2008) on non-exempted medium-sized companies, she found that the above mentioned variables still applied. Companies with these characteristics had indicated that they would continue to have their accounts audited even if the exemption were extended to them.

In 1994, Canada amended its Business Corporations Act and made audit voluntary for certain companies. Senkow *et al.* (2001) surveyed 896 companies which had been exempted from mandatory audit and found that about three quarters of the respondents continued to have their accounts audited. Companies which found audit beneficial were more likely to retain audit after its deregulation. However, the most significant factor was the existence of an agreement between the company and its lender requiring the company to provide audited accounts to the lender.

Australia deregulated audit requirement in 1971. Carey *et al.* (2000) found a positive correlation between demand for external auditing and the proportion of non-family management, non-family directors and level of debt. However, there was no significant support for the hypothesis that the demand was positively correlated to the size of the company. Of the 186 companies studied, 86 (46%) engaged an external auditor. 100 companies (59%) had an internal auditor, and 73 of which (66%) engaged an external accounting firm to assist in the function. Furthermore, 63 companies (57%) voluntarily engaged both internal and external audit services.

Studies were also conducted on the perception of audit exemption in some other commonwealth countries, namely, Hong Kong, Malta and Singapore. In 2001, Chung and Narasimhan studied the perception of small companies and small audit firms in Hong Kong on the value of small company audit. Both groups perceived audit to provide more benefits than the costs incurred. Thus, they would not advocate for the abolishment of mandatory audit. Until today, Hong Kong has retained statutory audit for all its operating companies.

Tabone and Baldacchino (2003) surveyed both local owner-managers of companies and auditors in Malta on the relevance of mandatory annual statutory audit requirement. The researchers found that both groups of respondents agreed that the owner-managers preferred to abolish the requirement although the auditors would prefer otherwise. What was striking was that both groups agreed that statutory audit was relevant to other stakeholders such as financiers and tax authorities. They were of the opinion that audit improved the reliability of the financial statements. Similarly, the local managers indicated that they expected a higher degree of added value from the auditors' services, such as advices on tax planning, cash-flow planning and internal controls. Like Hong Kong, Malta still practices mandatory audit.

In 2000, the Institute of Certified Public Accountants of Singapore (ICPAS) did a survey on banks, small companies and ICPAS members, and found that 50% of the small companies surveyed did not employ a qualified accountant. Possibly arising from this, the majority of auditors confirmed that they had to correct the accounts prepared by their clients. In the survey, the banks were the proxy for the other stakeholders of small companies and 94% of the respondent bankers agreed that they relied on audited accounts most of the time. Indeed, all banks surveyed insisted that their borrowers should provide their audited accounts even where collaterals were provided. The study also examined the impact of audit exemption on the revenue of auditors. It was anticipated that small audit firms might lose about 60% of the total

income, if voluntary audit were implemented for small companies. Based on the results of the survey, the ICPAS recommended retaining the mandatory audit requirement. However, this did not deter the legislation. Audit exemption was introduced in 2003 despite the 'protest' recorded.

### THE POSITION IN MALAYSIA

In 2009, the Malaysian Corporate Law Reform Committee (CLRC), in its Final Report, recommended the retention of mandatory audit for all companies, but powers should be given to the Companies Commission of Malaysia to exempt small companies from this requirement. The Committee suggests that the criteria for "small company" should be based on the number of the company's shareholders, annual turnover, balance sheet and number of employees (SSM, 2009). Thus, the possibility of the mandatory audit regime for small companies being overturned cannot be ruled out. What then is the impact of this on audit firms?

The studies by Carey *et al.* (2000), Senkow *et al.* (2001) and Seouw (2001), on the scenario after the audit had been made voluntary in Australia, Canada and the UK respectively, showed that the situation was not as grim as anticipated by some of the respondents in the pilot study conducted by Khairinuddin (2005) and by the respondents in Salleh *et al.* (2008). In Carey *et al.* (2000), the majority of the companies surveyed in Australia voluntarily engaged either external or internal audit, or both types of audit, whereas Senkow *et al.* (2000) found that three quarters of the respondents surveyed continued to have their accounts audited despite the exemption.

In Khairinuddin (2005), only 23% of the respondents indicated that they would not continue with the audit if given the choice. This was supported by CLRC (2007), whereby 29% of the respondents gave a similar indication. Thus, the majority would still continue to have their accounts audited even if they were conferred exemption. Following Collis (2008), this prediction may be relied upon. Collis (2008) did a longitudinal analysis among respondents

who had participated in a previous study (Collis *et al.*, 2004). In the 2004 study, 54% answered that they would opt for voluntary audit even if they were exempted from mandatory audit. When the exemption was extended to them, 52% of the same respondents did continue to have their accounts audited.

Thus, though the revenue of small firms which relied on audit work would be reduced if and when voluntary audit among the small companies were implemented in Malaysia, the revision of policy should not cause firms to wind-up their businesses. Clients who perceived audit to be beneficial would continue to have their accounts audited. As discussed above, previous studies showed that companies which perceived so would most likely continue with audit.

#### THE WAY FORWARD FOR AUDITORS

Previous studies in other countries (Tauringana & Clarke, 2000; ICPA, 2000; Chung & Narasimhan, 2001; Senkow *et al.*, 2001; Tabone & Baldacchino, 2003; Collis *et al.*, 2004; Collis, 2008) have shown that companies which derived benefits from audit would most likely demand audit. In Malaysia, surveys among the senior management of small companies also support this hypothesis (Khairinuddin, 2005; CLRC, 2007).

In Khairinuddin (2005), the respondents who perceived that they obtained high value from audit, *i.e.* the audit provided more than one benefit to them, had indicated that they would continue with voluntary audit. According to the study, the top three benefits derived from audit were; firstly, it provided a check on accounting records and systems (99%); secondly, audit helped to protect against fraud (85.5%); and thirdly, it improved the credibility of the financial statements (85%). The majority of the respondents in CLRC (2007) also perceived these as the benefits of an audit. In sum, the respondents from the Malaysian studies viewed auditors as independent and competent third parties who could verify the accounts.

As audit for small companies may eventually be waived, it is important for both audit firms and the audit industry to ensure small companies and their stakeholders continue to appreciate its value and relevance. This is no easy task in the light of global accounting frauds that were committed and not revealed in the audited reports. Among several notable audit failures in the recent years are Enron and WorldCom in the United States, Satyam in India and Akai Holdings (a company listed in Hong Kong before it became insolvent). In the case of Akai Holdings, Ernest & Young was the auditor, and on 23 September 2009, the audit firm agreed to settle the law suit for negligence for USD200 million (Rovnic & Yiu, 2009). Furthermore, in the global financial crisis, some banks collapsed almost soon after their auditors issued unqualified audit reports (Sikka *et al.*, 2009).

As a result of these scandals involving auditors, questions have been raised as to the quality of audit performed (Cousins *et al.*, 1999; Sikka *et al.*, 2009). The perceived benefits may be negated. The auditors' perception that the benefits of audit outweighed the costs (Salleh *et al.*, 2008) would be irrelevant if these are not shared by the small companies and their stakeholders. Thus, it is important for auditors to perform good audit.

In order to assure other interest groups that audit is worthy, the audit community should push for reforms in the industry instead of lobbying to cap auditors' liability which gives the wrong signal to other interest groups, *i.e.* that the auditors are not accountable for audit failures (Sikka *et al.*, 2009). Action should be taken to reassure the public that the auditors are socially responsible and provide "value for money" services (Cousin *et al.*, 1999). Achieving this will make external auditing an indispensable link in the financial reporting value chain. Auditors should become credible gatekeepers of financial information (Coffee, 2002).

Another aspect which the community must work on is the independence of auditors (Sikka *et al.*, 2009). Shareholders usually approve the auditor who is nominated by the directors.

Moreover, the auditor's remuneration is usually decided by the directors. The directors' role in the appointment and remuneration of the auditor makes the auditor financially dependent upon them. In order to overcome this conflict of interest, Sikka *et al.* (2009) suggested that auditors be appointed and remunerated by an independent body. This reform should further enhance the representation, value and quality of an audit, and thus, be considered by the legislators.

Further, Devi and Samujh (2010) found that auditors in small firms in Malaysia may offer a wide range of business services to small companies, including business coaching, grant application, strategic planning, internal controls, liquidation or corporate recovery and internal audit. In this aspect, the Malaysian Institute of Accountants could play an important role in providing training and enhancing the skills of auditors in these areas, as well as ensuring the auditors' relevance if and when audit is made voluntary for small companies.

#### **THE WAY FORWARD FOR THE REGULATOR**

Khairinuddin (2005) found that small companies which relied on external financing, such as banks, strongly favoured voluntary audit. These companies also indicated that the financiers would require a copy of the audited accounts. In such situation, the financier acts as "a pseudo regulator" (Abdel-Khalik, 1993). Such a company has no choice but to have its accounts audited, failing which the company may suffer the risk of having its loan recalled. As a result of the presence of the "pseudo regulator", making audit voluntary makes no difference to the company.

However, there may be other stakeholders who do not have the economic power to require the company's accounts to be audited in the event the requirement is waived. There may also be disputes between shareholders of a small company, and in such circumstances, audited accounts can be critical (Freedman & Godwin, 2003). Thus, in the event mandatory

audit is deregulated, there should be procedure in place to protect the minority shareholders and other stakeholders of the company. There is a need to strike a balance between the interests of the small company not to have its accounts audited and that of other interest groups, such as the company's shareholders and creditors, and tax authorities. The exemption of a company from audit should not be absolute. Lessons may be drawn from the countries which have obliterated mandatory audit for companies of certain economic size, such as the UK, Australia and Singapore.

In the UK, persons holding at least 10% of the shares in a company, which is exempted from audit, may require the company's accounts to be audited (Section 476 of the Companies Act 2006). In Australia, an exempted company is required to audit its accounts if requested by shareholders holding at least 5% of its voting shares or by the regulator (Section 292 of the Corporations Act 2001). Singapore apparently adopts the Australian model (Sections 205B and 205D of the Singaporean Companies Act, Cap 50).

The writer suggests that if and when Malaysia deregulates audit, the country should also adopt the Australian model which is more stringent compared to the UK model. Not only the threshold for the shareholders' requisition for audit is lower, the Australian model also gives power to the regulator to compel the company's accounts to be audited if the company commits a breach or if public interest dictates it.

#### **CONCLUSION**

In deciding whether to deregulate audit, the protection of the small audit firms should not be the primary determining factor. The interest of other stakeholders, such as the companies, shareholders, creditors and authorities, should also be considered. The regulator has the task to formulate the right threshold, which should be reviewed from time to time.

Some previous studies from other countries, which have liberalized audit, revealed that companies which perceived that they would

benefit from the audit would continue to have their accounts audited. Thus, it is timely for auditors to review their role to ensure that audit remains relevant and continues to be a vital link in the financial reporting value chain. Once this is in place, there should be a demand for audit even by companies that are exempted from the requirement. The small audit firms which produce quality audit work should be able to survive.

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