

**The Australian National University**  
**School of Accounting and Business Information Systems**

**The Effects of a Client's Political Connections on  
Auditors' Judgements**

**A thesis submitted for the degree of  
Doctor of Philosophy of  
The Australian National University**

**By**

**Mohd Radzi Md Jidin**

**April 2011**



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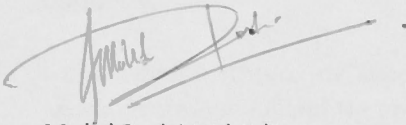
JUDITH ANNE MILLER

April 2011



## Declaration

I hereby declare that unless otherwise indicated, this thesis is the product of my own work.



Mohd Radzi Md Jidin

April 2011

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## Abstract

This thesis investigates the effects of a client's political connections on auditors' assessments of business risk, fraud risk and error risk, required audit effort and recommended audit fee in an experimental setting. Using a 1 x 3 between subjects design, political connections is manipulated at three levels: (1) ruling party connections; (2) opposition party connections; and (3) no political connections. A sample of auditors was presented with experimental case materials containing one of the three treatments and additional background information about an audit client. After the auditors read the case materials, they made an assessment of the client's business risk, listed the factors that increased and decreased their assessment of the client's business risk, assessed the client's fraud risk and error risk and made a judgement of the amount of audit effort required and indicated the audit fee they would recommend that the client be charged.

The results indicate that auditors in the ruling party connections group are more likely to list political connections as a factor that decreases a client's business risk, while auditors in the opposition party connections group are more likely to list political connections as a factor that increases a client's business risk. Auditors' assessments of business risk are higher for a client with ruling party or opposition party connections compared to a client with no political connections. There is no significant difference in the business risk assessments of the ruling party and opposition party connections groups. Average fraud risk assessments are higher for a client with ruling party or opposition party connections compared to a client with no political connections but not significantly different between a client with ruling party

connections and one with opposition party connections. Error risk assessments are higher for a client with ruling party connections than for a client with opposition party connections or no political connections. Clients with ruling party connections are allocated higher levels of required audit effort and higher audit fees are recommended compared to a client with opposition party connections or no political connections. The assessments of the audit effort required are higher for a client with opposition party connections compared to a client with no political connections. However, there is no significant difference in the average recommended audit fee for a client with opposition party connections or no political connections.

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# CHAPTER 1

## Introduction

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### 1.1 Introduction and Motivation

Anecdotal evidence suggests that one common characteristic of firms involved in major fraud cases such as Satyam, Enron, Madoff Investment Securities, Stanford Group, Fannie Mae and Freddie Mac is their strong political connections to those in power (e.g., Goldfarb, 2010; Labaton and Savage, 2009; Continetti, 2009; Kripalani, 2009; Timmons, 2009; Giroux, 2008; Day and Hilzenrath, 2003; Hunt, 2002). Delays in fraud detection by auditors and the relevant authorities raised questions regarding the potential influence of political connections on the judgments of auditors and the relevant authorities. Recent archival research finds that fraudulent firms with political connections to those in power have a higher probability of avoiding fraud detection by regulators (Yu and Yu, forthcoming) and are less likely to be involved in SEC enforcement actions (Correia, 2010). Such firms increase the strength of their political connections by making more political contributions after they committed fraud (Yu and Yu, forthcoming) as well as during the misreporting period (Correia, 2010). The contributions are mainly targeted to Congressional Committees with strong ties to the Securities and Exchange Commission (SEC) (Correia, 2010).

Despite the findings that a firm's political connections are associated with delays in fraud detection by regulators (Correia, 2010; Yu and Yu, forthcoming) and the various effects of political connections, including their effects on financial reporting (e.g., Cooper, Gulen and Ovtchinnikov, 2010; Chaney, Faccio and Parsley, 2011; Chen, Ding and Kim, 2010; Shon, 2010; Goldman, Rocholl and So, 2009; Bunkanwanicha and

Wiwattanakantang, 2009; Jiang, 2009; Malesky and Taussig, 2009; Boubakri, Cosset and Saffar, 2009; Li, Meng, Wang and Zhou, 2008; Claessens, Feijen and Laeven, 2008; Goldman, Rocholl and So, 2008; Knight, 2007; Leuz and Oberholzer-Gee, 2006; Faccio, 2006; Khwaja and Mian, 2005; Chiu and Joh, 2004; Fisman, 2001), no prior research examines the effect of political connections on the judgement of auditors, who are responsible for providing reasonable assurance that the firm's financial statements are free of material misstatement due to error and fraud (Auditing Standards ISA 315 and ISA 240). Auditing standard ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* requires auditors to obtain an understanding of the client and its environment (including its internal control) and to use that understanding when assessing the client's business risk and the risks of material misstatement. Therefore, understanding the relationships that a client has established with various external organisations and individuals, including with government, political parties and politicians, is an important component of an effective audit process.

Prior research that examines political connections in the auditing domain is pioneered by Gul (2006), who examines the relationship between political connections and audit fees. He finds that, as the result of the Asian financial crisis, the increase in audit effort and audit fees for politically connected firms in Malaysia is higher than for non-politically connected firms due to perceived higher risks of financial statement misstatement for politically connected firms. However, the introduction of capital controls by the Malaysian government leads to a decline in audit fees for firms with political connections. He argues that the capital controls were introduced to assist

politically connected firms recover from the crisis, which, in turn, reduces the risks of financial statement misstatement.

Motivated by Gul (2006), a number of other studies also examine the association between political connections and audit fees using Malaysian data (Bliss, Gul, Sun and Majid, 2008; Wahab, Zain, James and Haron, 2009; Rahman, Wahab and Zain, 2010). Unlike Gul (2006), which examines whether the introduction of capital controls by the Malaysian government benefits politically connected firms during the Asian financial crisis, the other studies only examine the association between political connections and audit fees without referring to any particular event where politically connected firms could potentially receive benefits by virtue of their connections.

Virtually all prior studies that examine the relationships between political connections and various factors are conducted using publicly available archival data. Archival research provides evidence on the association or correlation between independent and dependent variables. It does not, however, demonstrate a causal relationship between the variables. The inherent limitations of an archival research approach make it impossible for researchers to conclude that the observed phenomenon is caused by the independent variables. For example, although Gul (2006) finds an association between firms' political connections and audit fees, it is difficult to establish a causal inference that the differences in audit fees charged to politically connected and unconnected firms are caused by their political connections.

In the context of auditing, another limitation associated with archival research that examines the association between the risks of material misstatement and audit fees is the lack of a direct measure for the risks of material misstatement. Instead of measuring the client's risks of material misstatement, archival researchers can only

infer the level of client's risks of material misstatement based solely on proxies for these risks. For example, in developing a hypothesis that the introduction of capital controls by the Malaysian government leads to a decline in audit fees for politically connected firms, Gul (2006, p. 938) argues that "since capital controls and various subsidies assisted politically favoured firms financially, it is likely that managers of these firms had less incentive to misstate financial statements after the controls were in place", hence the politically connected firms "would be perceived by auditors to be associated with relatively less audit risk". Although Gul (2006) finds supports for the hypothesis, the fact that the client's risks of material misstatement are not being measured explicitly raises questions as to whether the decline in audit fees is caused by lower risks of material misstatement due to the introduction of the capital controls or is caused by other factors.

Furthermore, while prior archival studies demonstrate that audit fees charged to politically connected clients are significantly different than audit fees charged to non-politically connected clients (Gul, 2006; Wahab et. al, 2009; Rahman et al., 2010), these studies do not provide clear evidence on whether the fee difference is attributable to the differences in the risks of material misstatement and the allocation of audit effort between the clients or the fee difference reflects an audit fee premium being charged either to politically connected or non-politically connected clients.

Given the limitations of archival research, this thesis extends the work of Gul (2006) by using an experimental approach to examine the effects of political connections on auditors' judgements. Instead of just examining the relationship between political connections and audit fees, as in Gul (2006), this study examines whether auditors view a client's political connections as a factor that increases or

decreases the client's business risk as well as whether the client's political connections affect their assessments of business risk, error risk and fraud risk. As in Gul (2006), this thesis also examines the effects of political connections on auditors' decisions regarding required audit effort and their recommended audit fee.

Consistent with Gul (2006), which uses Malaysian data, this thesis examines the effect of political connections on the judgments of auditors in Malaysia. Malaysia provides an appropriate context for this study given the nature of its political economy where patronage, rent seeking behaviours and political connections are prevalent in the Malaysian corporate sector (Faccio, 2006; Gul, 2006; Johnson and Mitton, 2003; Gomez and Jomo, 1997). The Malaysian government acknowledged the prevalence of political connections in the country in the New Economic Model (NEM) unveiled by the Malaysian Prime Minister on 30 March 2010. One of the issues highlighted is the need to eliminate unnecessary cost of doing business contributed by "rent-seeking, patronage and often opaque government procurement" (National Economic Advisory Council, 2010, p. 7). By focusing on Malaysia, this study overcomes many potential confounding effects associated with cross-country research. Different economic, legal, political, social and cultural environments make data analyses and interpretation of cross-country research problematic (Miller, 2004). Miller (2004, p. 266) suggests that a focus "on a country or region of the world that demonstrates a more general issue in international research", allows researcher to design variables "that more cleanly capture the construct being measured".

The focus on Malaysia allows the development of more realistic case materials where the information provided can be tailored to the scenario that exists in the country without the need to develop case materials that are applicable to a wide range



of countries. The fact that patronage, rent seeking behaviours and political connections are prevalent in the Malaysian corporate sector allows for a more realistic manipulation of the independent variable for this research, i.e., political connections, which is manipulated at three levels: political connections with leaders in the ruling party (hereafter ruling party connections), political connections with leaders in the opposition party (hereafter opposition party connections) and no political connections.

## **1.2 Contributions**

The contributions of this research to the literature, research method, theory, practice and policy decisions are discussed in the following subsections.

### **1.2.1 Contribution to Literature**

This thesis makes a number of significant contributions to literature. First, it adds to the literature that examines the association between political connections and market participants' decisions and perceptions. Prior research provides evidence of an association between a firm's political connections and fraud detection by regulators as well as the perception of investors that political connections are valuable for politically connected firms. This thesis demonstrates the effects of a firm's political connections on the judgements of another market participant, i.e., auditors. Unlike research that uses an archival approach, this is the first political connections research study that utilises an experimental approach.

Second, by examining the effect of political connections on auditors' judgements when assessing risks, making decisions about the required audit effort and recommending an appropriate audit fee, this study adds to the literature that



demonstrates the effects of client characteristics and the environment on auditor judgements (e.g., Gramling, O'Donnell and Vandervelde, 2010; Cohen, Krishnamoorthy and Wright, 2008; Cohen, Krishnamoorthy and Wright, 2007; Ballou, Earley and Rich, 2004; Chang and Hwang, 2003; Cohen, Krishnamoorthy and Wright, 2000; Cohen and Hanno, 2000). Given that gaining an understanding of the client and its environment is required by auditing standard ISA 315, this thesis adds to the auditing literature by suggesting that client's relationships with political parties and/or political leaders is another factor that auditors should consider when assessing the risks of material misstatement.

Third, by providing participants in the experiment with a scenario similar to the one studied by Gul (2006), the results of this study are comparable to the findings in Gul (2006). He investigates the effects of political connections on politically connected firms at the onset of the Asian financial crisis and after the introduction of capital controls by the Malaysian government in its effort to bring the country out of the Asian financial crisis in 1998. In this thesis, the economic stimulus package introduced by the Malaysian government during the global economic crisis in 2008 is used to provide a scenario similar to the introduction of the capital controls in 1998. Participants in the current study are required to make a number of judgements based on the scenario provided. The results of this research indicate that auditors recommend a higher audit fee for a client with ruling party connections compared to a client with no political connections. Although the findings in this study indicate that auditors in the ruling party connections group perceive political connections as a factor that increases the likelihood of a client achieving its business objectives (due to potential benefits to be received from political connections), this does not, however, translate into lower

assessed risks of material misstatement. Instead, the assessment of the risks of material misstatement (due to error and fraud) is higher for ruling party connected firms compared to non-politically connected firms. This in turn, leads to a higher recommended audit fee for a ruling party connected firm.

Fourth, by providing evidence that a client's political connections affect audit fee recommendations, this research adds to the audit fee literature that investigates the determinants of audit fees (e.g., Hay, Knechel and Wong, 2006; Abbott, Parker, Peters and Raghunandan, 2003; Carcello, Hermanson, Neal and Riley, 2002; Beaulieu, 2001; Behn, Carcello, Hermanson and Hermanson, 1999; Simunic, 1980). Given that most audit fee studies are conducted using archival data, this research adds to the limited number of audit fee studies that use an experimental approach (e.g., Johnstone, 2000; Houston, Peters and Pratt, 1999; Pratt and Stice, 1994).

Fifth, this study adds to the literature that examines the links between political connections and the Malaysian corporate sector (e.g., Rahman et al., 2010; Wahab et al., 2009; Bliss et al., 2008; Gul, 2006; Adhikari, Derashid and Zheng, 2006; Johnson and Mitton, 2003; Gomez and Jomo, 1997). Prior studies either discuss the theoretical links between political connections and the corporate sector in Malaysia or provide evidence of an association between political connections and the corporate sector through archival research. This thesis validates the arguments in the prior literature that political connections do affect the judgement of market participants in Malaysia, in this case, auditors.

### 1.2.2 Contribution to Research Method

The use of an experiment to examine the effects of a client's interactions and relations with the external environment (in this case through political connections) on auditors' judgement is the main research method contribution of this study. The absence of prior experimental research examining the effects of political connections on the judgments of auditors may be attributable to the difficulties and complexities in designing appropriate experimental materials including the manipulation of the independent variable, political connections.

The fact that a client operates in a complex web of relationships with various external parties and the impact of the changes in the external environment on a client's performance make the manipulation of the independent variable difficult. Various factors need to be considered in order to ensure that the manipulation of the independent variable achieves the intended outcomes. This research provides some insights into the development of appropriate case materials that involve the manipulation of a complex independent variable.

Furthermore, prior experimental studies that examine auditors' recommended audit fees measure auditors' audit fee recommendations by requesting auditors to indicate the audit fee they would recommend the client be charged on a 10-point scale (Pratt and Stice, 1994) or an 11-point scale (Houston et al., 1999) anchored by 1 = Much lower than normal and 10/11 = Much higher than normal. This thesis adds to the way that auditors' recommended audit fees are measured. In addition to requesting auditors to indicate the audit fee they would recommend the client be charged on a 7-point scale, auditors are also required to indicate the dollar amount of the fee they would recommend the client be charged. For this measure, auditors are provided with

the current year's audit fees for two clients in the same industry that are comparable in size and complexity to the client under audit together with the assessed level of risks of material misstatement in the financial statements. Based on this information, participants indicate the audit fee they would charge the client (Refer to Section 4.4). This method provides an alternative way to measure auditors' recommended audit fees in experimental audit fee research.

### **1.2.3 Contribution to Theory**

The main contribution to theory of this thesis is the use of resource dependence theory in explaining how political connections create value to firms through politically connected boards of directors. Until now, there has been little use of resource dependence theory in the auditing literature. The only two auditing studies to date that use resource dependence theory are an experimental study by Cohen et al. (2007) and a theoretical paper by Cohen et al. (2008). In discussing the use of the resource dependence perspective in future corporate governance research, Cohen et al. (2008, p. 191) suggest that future research should consider "how does the role of the board in helping to set corporate strategies (resource dependence) affect business risks and the resulting reporting of financial performance (estimates, uncertainties, etc.)?".

Applying resource dependence theory in this thesis implies that auditors would perceive political connections as a factor that decreases a client's business risk for a client with ruling party connections where the majority of the client's board of directors are connected to the party or leaders currently in power. On the other hand, auditors would perceive political connections as a factor that increases a client's

business risk for a client with opposition party connections where the majority of the client's board of directors are connected to the opposition party or the opposition leaders.

Consistent with the resource dependence perspective, the results of this study indicate that auditors in the ruling party (opposition party) connections group are more likely to identify political connections as a factor that decreases (increases) a client's business risk. The differences in auditors' perceptions of whether political connections increase or decrease a client's business risk, however, does not translate into a difference in the subsequent business risk assessment where there is no significant difference in the business risk assessments between auditors in the ruling party connections and opposition party connections groups. The results indicate that differences in auditors' perceptions of the resource dependence role of the board do not necessarily lead into a difference in their assessments of the client's overall business risk.

#### **1.2.4 Contribution to Practice**

The issue examined in this thesis is important to business, regulators, standard setters and the auditing profession. It is of interest to boards of directors of firms that currently have ruling party connections in considering the cost and benefits associated with the rent seeking behaviours in establishing and maintaining the political connections. Similarly, the findings of this research provide insights to boards of directors of opposition party connected firms as to the potential costs and benefits of being connected to the opposition party. For boards of directors in non-politically

connected firms contemplating establishing political connections either with the ruling party or opposition, the findings of this study are important to them.

The results of this thesis could also be important to multinational companies currently operating or considering establishing operations in countries where the relationship between political connections and the corporate sector are crucial. Although the influence of political connections on business is widespread, it is more prevalent in some countries than others (Faccio, 2006). The influence of political connections on business could affect a multinational company's resource allocation decisions (Chen et al., 2010).

Furthermore, the results of this thesis could be useful to various market participants, particularly regulators. The results of this study provide complementary evidence to support the findings of prior archival research that there is an association between a firm's political connections and the effectiveness of regulatory enforcements (Yu and Yu, forthcoming; Correia, 2010). Although critics could argue that the findings in prior research are mere associations between a firm's political connections and the effectiveness of regulatory enforcements, the findings in the current research provide evidence that a firm's political connections do have an impact on the judgement and decision-making of market participants, in this case, auditors.

In addition, the results of this research should be of interest to standard setters and the auditing profession in general. Although auditors are not explicitly required by auditing standards to consider a client's political connections during the audit, this research provides evidence that auditors do consider a client's political connections in their risk assessments and their determination of the required audit effort and recommended audit fee. The influence of a client's political connections on their risk



assessments could influence their audit strategy, hence affecting the efficiency and effectiveness of the audit. By ignoring a client's political connections when analysing the client and its environment, auditors may risk underestimating or overestimating a client's business risk, and as a consequence, the risks of material misstatement.

### **1.2.5 Contribution to Policy Decision**

As this research is conducted using Malaysian auditors as participants, the findings of this research are relevant to policy decisions of the Malaysian government, particularly in the context of the New Economic Model (NEM). The NEM unveiled on 30 March 2010 is a holistic plan by the Malaysian government that aims to transform Malaysia into a high income economy with quality growth. The NEM was developed by the National Economic Advisory Council (NEAC). One of the issues highlighted in the NEM is the need to eliminate unnecessary costs of doing business contributed by "rent-seeking, patronage and often opaque government procurement" (National Economic Advisory Council, 2010, p. 7). According to NEAC, the government needs to have the political will to implement the initiatives proposed in the NEM as "opposition is expected from beneficiaries of all kinds of rent-seeking activities" and suggested that "resistance from these groups must be met head on, but there must be a process to allow for feedback and review" (National Economic Advisory Council, 2010, p. 36).

Since the patronage system and rent seeking behaviours have been part and parcel of the Malaysian political economy for decades (Gomez and Jomo, 1997), the government plans to dismantle the system and eliminate the rent seeking behaviours, may lead to opposition from firms that obtain favours and benefits through the political connections that they have established with leaders in the ruling party. The



results of this study provide evidence to ruling party connected firms that despite the benefits received by such firms, there are significant costs associated with political connections, i.e., auditors who are responsible for providing an opinion on a firm's financial statements perceive that ruling party connected firms are more risky than non-politically connected firms, which results in higher recommended audit fees for ruling party connected firms. In addition, the findings of this study also validate the NEAC concern that the patronage system and rent seeking behaviours lead to higher costs of doing business in Malaysia.

### **1.3 Structure of the Thesis**

Chapter 2 contains a detailed review of the literature relevant to this thesis. The literature review begins with a discussion of the various definitions of political connections used in the literature. This is followed a review of the literature that examines the various effects of political connections on firms. Chapter 3 covers the development of the hypotheses examined in this research. Chapter 4 discusses the research method used in the thesis. It first describes the research design and the manipulation of the independent variable. This is followed by a detailed discussion on the development and administration of the research instrument. Chapter 5 presents the results of the experiment. The analysis and results for H1 to H6 are discussed in detail in this chapter. The findings are generally support the hypotheses. Finally, Chapter 6 provides a summary of the findings from this thesis. This is followed the discussion about the limitations of the research and the future opportunities from this research.

There are two appendices presented at the end of this thesis. Appendix 1 presents the information sheet, consent form and voucher payment form provided to participants. Appendix 2 presents the research instruments used in this study.

# CHAPTER 2

## Literature Review

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### 2.1 Introduction

This chapter reviews the literature relevant to the current research. Section 2.2 describes resource dependence theory and its relation to political connections. This is followed by Section 2.3, which discusses political connections in detail. This section starts with a discussion on the definition of political connections. It then discusses the literature on political connections. The discussion is divided into six subsections: (1) political connections and firm value; (2) political connections and favours from government; (3) political connections and firm performance; (4) political connections and access to finance; (5) political connections, accounting quality and corporate governance; and (6) political connections in Malaysia. Section 2.4 summarises and concludes the chapter.

### 2.2 Resource Dependence Theory

Resource dependence theory (RDT) is used to explain how political connections create value for a firm. RDT posits that the survival and success of a firm is dependent on its ability to access and maintain control over needed external resources (Pfeffer, 1972, Pfeffer and Salancik, 1978; Boyd, 1990; Das and Teng, 2000; Hillman, Withers and Collins, 2009). Pfeffer and Salancik (1978, p. 2) argue that “organisations must transact with other elements in their environment to acquire needed resources”. The degree of the dependency on the external environment for scarce resources and the

extent of uncertainty in that environment affect the way a firm is managed and structured (Ulrich and Barney, 1984).

According to RDT, one of the mechanisms to manage relationships with the external environment is through a board of directors (Pfeffer, 1972; Pfeffer and Salancik, 1978; Boyd, 1990; Dalton and Daily, 1999; Dalton, Daily, Johnson and Ellstrand, 1999; Hillman and Dalzier, 2003; Hillman, Cannella and Paetzold, 2000; Daily, Dalton and Cannella, 2003; Hillman, 2005; Cohen et al., 2008; Davis and Cobb; 2010). Based on Pfeffer and Salancik (1978), Hillman et al. (2000) outline four primary benefits provided by a board of directors: (a) advice and expertise provided, which is based on the individual board member's experience in various strategic areas; (b) medium of communication and information between the external organisations and the firm; (c) legitimacy; and (d) access to preferential treatments from important elements in the external environment. The directors who act as a communication medium between the firm and the external environment and the directors who provide access to preferential treatment from important elements outside the organisation are the focus of this research. The important elements in the external environment range from entities such as suppliers, financial institutions and various government organisations such as ministries, government agencies, government linked banks, etc.

The extent of linkages to the external environment required to be established by the board depends on the nature of a firm's business. Dalton and Daily (1999) assert that directors who have connections in the external environment enhance a firm's ability to get access to valued resources, information and networking. For example, the authors provide anecdotal evidence that Vernon Jordan was appointed to the board of

more than 10 firms (such as American Express, Callaway Golf, Dow Jones, Sara Lee, Xerox, etc.) mainly due to his connections to important people that are crucial to the firms' success.

Using the benefits outlined by Pfeffer and Salancik (1978) and some common characteristics of directors in large public firms, Hillman et al. (2000) develop a taxonomy that identifies the roles of directors within the resource dependence framework. They categorise directors into four categories: (i) insiders (e.g., current and former officers of the firm); (ii) business experts (e.g., current and former executives of other firms or current directors of other firms); (iii) support specialists (e.g., lawyers, bankers and public relation experts); and (iv) community influentials (e.g., political leaders or leaders of social/community organisations).

Two categories of directors are the focus of this research. The first category is insiders who are inside directors. Although insiders mainly provide the board with firm specific information (Raheja, 2005; Fama and Jensen, 1983), some resourceful insiders "may have varying attributes that could supply valuable resources from the external environment" (Hillman et al., 2000, p.240). These insiders may have specific connections or linkages with the external environment. Another category of directors is community influentials. Directors in this category include political leaders "with experience and linkages relevant to the firm's environment beyond competitor firms and suppliers" (Hillman et. al., 2000, p.241). The political leaders of interest in this thesis are the current or former members of parliament or leaders of political parties at the constituency or division levels. Political leaders who are appointed as directors can provide relevant political connections to the important elements in the external environment, including the government and top political leaders who are currently in

power at the state and federal level. A firm with such political connections has a competitive advantage over its unconnected or opposition party connected peers. The existence of ruling party connections can enhance the ability of the firm to survive and achieve its business objectives. It also assists the firm in performing better than its competitors. The following section explains political connections in detail, including the definition, the costs and benefits associated with political connections, and political connections in Malaysia.

### **2.3 Political Connections**

Studies investigating the effects of political connections on firms define and measure political connections using a variety of different proxies. Table 2.1 provides a list of articles that examine the effects of political connections on firms and the measures they use to define political connections. Table 2.1 highlights the most common measures of political connections used in prior studies.

One of the most comprehensive definitions of political connections in the literature is provided by Faccio (2006). She examines firms' political connections in 47 countries. According to Faccio (2006, p.369), a firm is politically connected if "at least one of its large shareholders (anyone controlling at least 10% of voting shares) or one of its top officers (CEO, president, vice-president, chairman or secretary) is a Member of Parliament, a minister, or is closely related to a top politician or party". Faccio describes a large shareholder or top officer as closely related to a top politician or party if: (1) he/she is a friend of a head of state, minister or member of parliament; (2) he/she is a friend to former heads of state or prime ministers; and (3) he/she is a politician in another country. A firm is also considered as closely related if a current



minister was one of the large shareholders or one of the top officers in the firm before he/she entered politics. According to Faccio, close relationships also include a large shareholder or top officer who is known to have a close relationship with political parties and key government officials as identified by Gomez and Jomo (1997) and Johnson and Mitton (2003).

Gomez and Jomo (1997) provide an analysis of Malaysia's political economy including the political connections of Malaysian listed firms during the 1980s and 1990s. Gomez and Jomo consider a firm to be politically connected if one of the firm's top officers or large shareholders has a close relationship with any of the three key government officials (and political leaders) during that period: Prime Minister Mahathir, Deputy Prime Minister Anwar Ibrahim or Daim Zainuddin.<sup>1</sup> Johnson and Mitton (2003) identify politically connected firms in Malaysia based on the analysis provided by Gomez and Jomo (1997). Other studies use a number of different measures to define political connections.

Based on a review of the measures used in prior research, the measures are summarised and classified into seven categories in Table 2.1. The seven categories are:

- (1) one of the top officers/major shareholders is an active member of a political party;
- (2) one of the top officers/major shareholders is a current/former government official;
- (3) one of the top officers/major shareholders is a current/former member of

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<sup>1</sup> Daim Zainuddin was a close confidant of the then Prime Minister, Dr Mahathir. He was appointed as Minister of Finance between 1984 and 1991. At the onset of Asian economic crisis in 1997, he was recalled by Dr Mahathir to serve as the Executive Director of National Economic Action Council (1997-1998), Minister with Special Functions at the Prime Minister Department (1998-1998) and Minister of Finance (1999-2001).



parliament/senator/minister; (4) one of the top officers/major shareholders has a personal or family relationship with the current top political leaders or current/former head of state (e.g., Prime Minister or President); (5) corporate political contributions to political parties/election candidates or corporate lobbying; (6) government ownership in the firm; and (7) other measures. The top officer referred to in Table 2.1 includes not just the CEO, president, vice-president, chairman or secretary as in Faccio (2006), but also includes any member of the board of directors. Consistent with Faccio (2006), the major shareholders are those who control at least 10% of the voting shares.

An asterisk in the table indicates a reference to a measure used to define political connections. The name of the country in brackets under the name of the author(s) denotes the country where the data is collected. According to the articles included in Table 2.1, the most common measure to describe the existence of political connections is when at least one of the top officers or one of the major shareholders of a firm has a personal or family relationship with a top political leader or current/former head of state (e.g., Prime Minister or President). Another popular measure of political connections is when one of the top officers or one of the major shareholders is a current/former member of parliament/senator or current/former minister. These two measures are part of the definition of political connections provided by Faccio (2006). Most studies that use cross country data define political connection based on Faccio (2006), using either the exact definition provided by Faccio, part of it or a modified version of Faccio's definition (e.g., Boubakri, Guedhami, Mishra and Saffar, 2010; Guedhami, Pittman and Saffar, 2009; Richter, 2010; Chaney et al., 2011).

Studies that measure political connection based on corporate political contributions to a political party/election candidate and corporate lobbying are mainly conducted in the US (e.g., Roberts, 1990; Shon, 2010; Aggarwal, Meschke and Wang, 2011; Richter, Samphantharak and Timmons, 2009) because of availability of the necessary data in the US. The last column in Table 2.1, “Other measures” are measures of political connection that are not frequently used in the literature. These include a political appointment of the chairperson of state-owned banks by political parties (Sapienza, 2004), one of the top officers or major shareholders stood for office in national or provincial elections (Hillman, 2005; Khwaja and Mian, 2005; Bunkanwanicha and Wiwattanakantang, 2009), one of the top officers is from a particular state or region (Jiang, 2008; Roberts, 1990; Faccio and Parsley, 2009; Du, Tang and Young, 2009), affiliation with some level of government administration (Du and Girma, 2010) and a businessman who provided political support and advice to politician (Ferguson and Voth, 2008).

All prior studies that examine the effects of political connections on firms in Malaysia use the measure provided by Gomez and Jomo (1997) and Johnson and Mitton (2003) as a basis to identify politically connected firms. These studies use either the exact measure as provided by the two papers (e.g., Gul, 2006; Adhikari et al., 2006) or modified versions of it. The modified versions include: (1) the addition of firms that are owned by the government through various government agencies (Wahab and Rahman, 2009; How, Verhoeven and Wahab, 2009; Wahab et al., 2009; Rahman et al., 2010); and (2) the addition of firms that are identified as politically connected based on the definition provided by Faccio (2006), e.g., Bliss et al. (2008).

In the current study, a firm is considered as politically connected when a majority of the members of its board of directors is connected to either the top political leaders at the federal level who are currently in power or when a majority of the board is connected to the federal opposition leaders. The existence of political connections is manipulated at three levels namely, ruling party connections, opposition party connections and no connections. A firm is considered to have ruling party connections when a majority of its board members are connected to the top political leaders who are currently in power at the federal level. In contrast, a firm is considered to have opposition party connections if it is connected to the opposition parties or their leaders at the federal level. A firm is considered as having no connections if it is not connected in any way to any politician, political party or government. Section 2.3.6 discusses the nature of political connections in Malaysia, including the ruling party connections and opposition party connection while the operationalisation of the definition in the current research is discussed in detail in Section 4.3.1.

There are several strands of literature that analyse the impacts of political connections on firms. The review of the literature about the impacts of political connections on firms are classified into five topics namely: (1) political connections and firm's value; (2) political connections and favours from the government; (3) political connections and firm performance; (4) political connections and access to finance; and (5) political connections, accounting quality and corporate governance.

**Table 2.1: Measures Used to Define Political Connections**

Author (s)	One of the top officers/major shareholders is an active member of a political party	One of the top officers/major shareholders is a current/former government official	One of the top officers/major shareholders is a current/former member of parliament/senator/minister	One of the top officers/major shareholders has a personal or family relationship with a top political leader or current/former head of state (e.g., Prime Minister or President)	Corporate political contributions to political parties/election candidates or corporate lobbying	Government ownership in firms	Other Measures
Roberts (1990) [US]					*		*
Agrawal and Knoeber (2001) [US]		*					
Fisman (2001) [Indonesia]				*			
Kang (2002) [Korea]						*	
Gupta and Swenson (2003) [US]					*		
Johnson and Mitton (2003) [Malaysia]				*			
Ansolahehere, Snyder, Ueda (2004) [US]					*		

Chiu and Joh (2004) [Korea]				*	*		
Sapienza (2004) [Italy]						*	*
Dinc (2005) [Across countries]						*	
Khwaja and Mian (2005) [Pakistan]							*
Cheung, Jing , Rau and Stouraitis (2005) [China]						*	
Hillman (2005) [US]	*		*				*
Faccio, Masulis, and McConnell (2006) [Accross countries]			*	*			
Jayachandran (2006) [US]					*		
Charumilind, Kali and Wiwattanakantang (2006) [Thailand]				*			
Leuz and Oberholzer- Gee (2006) [Indonesia]				*			
Adhikari et al. (2006) [Malaysia]				*		*	
Gul (2006) [Malaysia]				*			
Faccio (2006) [Accross Countries]			*	*			

Fisman, Fisman, Galef and Khurana (2006) [US]				*			
Fan, Wong and Zhang (2007) [China]		*					
Knight (2007) [US]				*			
Wahab, How, Verhoeven (2007) [Malaysia]				*		*	
Bertrand, Kramarz, Schoar and Thesmar (2007) [France]		*	*				*
Jiang (2008) [China]	*	*					*
Claessens et al. (2008) [Brazil]					*		
Ferguson and Voth (2008) [Germany]					*		*
Bliss et al. (2008) [Malaysia]			*	*			
Dombrovsky (2008) [Latvia]			*				
Hung, Wong and Zhang (2008) [China]		*					



Boubakri, Cosset and Saffar (2008) [Across countries]		*	*	*			*
Li et al. (2008) [China]	*						
Goldman et al. (2008) [US]	*	*	*				
Wang, Wong and Xia (2008) [China]						*	
Malesky and Taussig (2009) [Vietnam]		*					
Du et al. (2009) [China]		*					*
Ghita, Cuyvers and Deloof (2009) [Belgium]			*				
Niessen and Ruenzi (2009) [Germany]			*				
Boubakri et al. (2009) [Across countries]			*	*			
Faccio and Parsley (2009) [Across countries]							*
Bunkanwanicha and Wiwattanakantang (2009) [Thailand]			*	*			*

Francis, Hasan and Sun (2009) [China]		*				*	
Goldman et al. (2009) [US]	*	*	*				
Wahab and Rahman (2009) [Malaysia]				*		*	
How et al. (2009) [Malaysia]				*		*	
Guedhami et al. (2009) [Accross countries]						*	
Wahab et al. (2009) [Malaysia]				*		*	
Richter et al. (2009) [US]					*		
Jiang (2009) [Across countries]			*	*			
Richter (2010) [Across countries]			*	*			
Shon (2010) [US]					*		
Cooper et al. (2010) [US]			*		*		
Correia (2010) [US]					*		
Gul, Kim and Qiu (2010) [China]						*	

Rahman et al. (2010) [Malaysia]				*		*	
Guedhami, Pittman and Saffar (2010) [Across countries]			*	*			
Boubakri et al. (2010) [Accross countries]			*	*			
Faccio (2010) [Across countries]			*	*			
Du and Girma (2010) [China]							*
Hill, Fuller, Kelly and Washam (2010) [US]					*		
Chaney et al. (2011) [Across countries]			*	*			
Chen, Li and Su and Sun (2011) [China]	*	*					
Aggarwal et al. (2011) [US]					*		
Yu and Yu (forthcoming) [US]					*		
Berkman, Cole and Fu (forthcoming) [China]			*			*	
<b>Incidence</b>	<b>6</b>	<b>12</b>	<b>21</b>	<b>26</b>	<b>14</b>	<b>15</b>	<b>12</b>

### 2.3.1 Political connections and firm value

There is a growing literature that examines the value of political connections to firms. It investigates how political connections affect a firm's value in various settings. Most of these studies are conducted using an event study methodology. These studies measure changes in the market value or stock returns of politically connected firms surrounding particular events. Market reactions to particular events reflect investors' beliefs about the value of political connections to the politically connected firms. Several studies utilise the event study methodology to examine the effect of election outcomes on the politically connected firms. These studies demonstrate how a firm's connection(s) to different individuals or political parties can affect the firm's value and stock returns following the election results. Knight (2007), Shon (2010) and Goldman et al. (2009) conduct event studies surrounding the 2000 US presidential election to examine the effects of the election outcome on firms connected to Bush and Gore. Knight (2007) analyses 70 politically sensitive firms classified as Bush-favoured or Gore-favoured firms. He finds that during the six months leading up to the election, the association between the market value and probability of a Bush victory varies positively (negatively) with the level of campaign contributions made to Bush (Gore).

Shon (2010) examines the association between campaign contributions and stock returns during the Florida recount period. He finds a negative (positive) relation between pre-election campaign contributions to Gore (Bush), who lost (won) the election, and stock returns of the firms that contributed to his campaign fund. Instead of using campaign contribution as a measure of political connections, Goldman et al. (2009) use a more direct measure of political connections, i.e., political connections of the board of directors. Their study finds that following the victory of Republican party

in the 2000 presidential election, firms connected to the Republican (Democratic) party exhibit an increase (decrease) in value.

Based on a comprehensive database of campaign contributions in the US from 1979 to 2004, Cooper et al. (2010) find a positive association between the extent of support for candidates and future abnormal returns for firms that contribute to the candidates. Firms that have longer relationships with the candidates and support more candidates from the same state that the firm is based show stronger correlations. The effect is also stronger for firms that contribute to more powerful candidates. Aggarwal et al. (2011) conduct a similar study using data from 1991 to 2004. Instead of looking at the number of candidates supported by a firm, Aggarwal et al. (2011) examine the dollar value of the donations. They suggest two views that may explain a firm's decision to establish political connections through political contributions, either as an investment in political capital (that should generate higher returns for the firm) or it represents an agency problem (that should generate lower returns for the firm). In contrast to Cooper et al. (2010), Aggarwal et al. (2011) find a negative correlation between the campaign donations and future excess returns. They argue that this reflects an agency problem where a firm does not have any political preference, but its managers do. This, in turn, lowers the firm's returns.

Similarly, Ghita et al. (2009) examine the shift of power from the Liberal party to the Catholic party in Belgium during the parliamentary election in 1870. They find that firms with directors who are politically connected to the Catholic party demonstrate a 10.8% higher return than unconnected firms, whereas firms with directors who are politically connected to the Liberal party demonstrate a 6.3% lower return than unconnected firms. In a similar study, based on a sample of firms in Brazil,

Claessens et al. (2008) demonstrate that a firm's campaign contributions are positively associated with its stock returns following the announcement of the elections results. Politically connected firms exhibit higher stock returns.

Prior research also documents that the market responds positively to the establishment or improvement of political connections in firms. Based on a study of political connections across 47 countries, Faccio (2006) provides evidence that the value of firms increases by over 2% following the announcement that an officer or a large shareholder of the firm is entering politics. In an event study based on a sample of 234 politically connected firms in 23 countries, Boubakri et al. (2009) demonstrate that the establishment of political connections leads to higher firm performance. Using data collected from the S&P 500 firms in the US, Goldman et al. (2009, p. 2336) show that the appointment of politically connected directors to the board is associated with positive abnormal stock returns following the announcement. The authors attribute the positive stock returns to the market's perception that "political connections create value by generating future benefits to the firm". Bunkanwanicha and Wiwattanakantang (2009) find that the valuation of firms connected to businessmen who won in Thailand's 2001 general election outperform unconnected firms by 160%. Ferguson and Voth (2008) conduct an event study following the Nazi "seizure of power" in 1933. They find that investors recognise the value of firms connected to the Nazi movement where these firms demonstrate unusually high returns compared to unconnected firms.

Another stream of research investigates the effects of the loss of political connections or the potential loss of such connections on a firm's value. This research argues that the loss or potential loss of connections affects the ability of politicians to



provide favours to politically connected firms. Roberts (1990) provides evidence that US firms connected to Senator Henry Jackson exhibit negative stock price reactions following the announcement of the Senator's unexpected death. On the other hand, firms connected to Senator Sam Nunn, who replaced Jackson as the Chairman of the Senate Armed Services Committee, show positive reactions. Jayachandran (2006) investigates the sudden change in the control of the US Senate from the Republicans to the Democrats after Senator Jeffords left the Republican Party and become an Independent. He finds that the market capitalisation of firms connected to the Republicans (through soft money donations) decreased by 0.8% per \$250,000 donated to the party in the previous election cycle. In contrast, the market capitalisation of firms connected to the Democrats increased by 0.4%.

Using Indonesian data, Fisman (2001) examines the value of firms politically connected to the Suharto family surrounding several announcements about the President's deteriorating health. He finds that firms connected to the Suharto family lost value following the announcement and suffered more compared to less connected firms. Based on data collected across several countries, Faccio and Parsley (2009) examine the value of politically connected companies headquartered in the politician's hometown following the sudden death of the politician. They argue that politicians tend to favour firms in their local constituency for a number of reasons, such as seeking re-election, creation of local jobs and networks of friends, family and local firms. They find that the value of such companies declined by 1.7% following the death of the politicians, which is followed by a drop in sales growth and access to credit. Fisman et al. (2006) investigate the unfavourable political and personal events that affected Vice President Cheney on the value of firms connected to him. In contrast to

Fisman (2001), Fisman et. al. (2006) find that the events have no effect on the share prices of firms connected to Cheney. They attribute the results to the nature of political connections in the US, which are facilitated by well organised institutions such as political action committees, which, in turn, control rent seeking behaviours. It is different than the more personalised connections that exist in other countries.

Another group of studies examines the effects of the introduction of new government policies or changes in existing policies to politically connected firms. Using data from publicly listed firms in Malaysia, Johnson and Mitton (2003) demonstrate that the introduction of capital controls by the Malaysian government during the Asian economic crisis benefited firms connected to Prime Minister Mahathir, but not those connected to the fired Deputy Prime Minister, Anwar Ibrahim. Johnson and Mitton (2003) assert that the introduction of the capital controls by the government is used to assist firms connected to the Prime Minister.

Leuz and Oberholzer-Gee (2006) provide evidence that firms connected to Suharto and his protégé, Habibie, outperform the less connected firms during the period when Habibie was President. However, firms connected to Suharto and Habibie underperform during the period when Wahid is President. During his administration, Wahid's government was against favouritism to Suharto's cronies. Leuz and Oberholzer-Gee (2006, p. 436) suggest that "firms have difficulty re-establishing connections with a new government when their patrons fall from power".

Ansola-behere et al. (2004) investigate the events surrounding the approval of the Bi-Partisan Campaign Reform Act in the US, which banned soft money contributions (i.e., contributions outside the direct contribution limits system). They hypothesise that if such contributions benefit the contributing firms, the decision to

ban soft money contributions should negatively affect firms that used soft money heavily. The research finds no difference between the valuation of firms that used large amount of soft money and firms that did not use it.

### **2.3.2 Political connections and favours from the government**

Another stream of literature demonstrates, in a more direct way, the favours received by politically connected firms from the government. Based on an analysis of firms in 35 countries during 1997-2002, Faccio et al. (2006) provide evidence that politically connected firms are more likely to be bailed out by the government compared to similar unconnected firms. The likelihood of being bailed out is higher when the home government received financial assistance from the International Monetary Fund (IMF) or World Bank (WB). They argue that this is evidence consistent with critics of the IMF and WB, i.e., that financial assistance provided by those organisations is used to support politically connected firms in the home country.

Goldman et al. (2008) examine the value of political connections by investigating the association between a firm's political connections and their likelihood of securing government procurement contracts. They investigate the political connectedness of S&P 500 firms' board members and the allocation of government procurement contracts to the firms before and after the 1994 mid-term elections and the 2000 presidential elections in the US. Goldman et al. (2008) demonstrate that firms connected to the winning (losing) party experience an increase (decrease) in procurement contracts. According to Goldman et al. (2008), the findings provide evidence that political connections play a part in the allocation of government procurement contracts and demonstrate that political connections create value for

firms. This is in line with Agrawal and Knoeber (2001), who find that politically connected directors are more prevalent in firms where sales to the government and export are greater.<sup>2</sup> They argue that when politics is an important determinant of firm profitability and success, such as in the case of government procurement contracts, the existence of politically connected directors adds value to the firms. Similarly, Du and Girma (2010, p. 532) demonstrate that the effects of political connections are more prevalent when firms require a broader range of resources in order to expand and “the ‘helping hand’ of government presumably needed more”.

Bunkanwanicha and Wiwattanakantang (2009) demonstrate that business owners in Thailand who rely on government contracts and concessions are more likely to run for office in the country’s election in order to obtain government favours in the allocation of procurement contracts and from legislative changes. The authors argue that holding a public office is an efficient way for a politically connected businessman to exert political influence for the benefit of their firms. On the other hand, based on the analysis of political connections created through campaign contributions, Aggarwal et al. (2011) find that the existence of political connections for firms in industries with a large percentage of sales to the government does not associate with higher returns. He attributes this to the agency problem associated with political contributions.

A number of studies examine the effect of a firm’s political connections on tax benefits. Using US data, Gupta and Swenson (2003) provide evidence that the enhancement of political connections through political action committee contributions

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<sup>2</sup> Boubakri et al. (2010) find that politically connected firms are common in the more regulated sectors.

and individual managers' contributions are positively correlated with the firm's tax benefits. They argue that the contributions reflect the rent seeking behaviour of firms and their managers. Adhikari et al. (2006) demonstrate that politically connected firms in Malaysia pay tax at lower effective rates than unconnected firms. They assert that the existence of various government supports to politically connected firms, such as special tax deductions and various tax breaks, could have contributed to the lower effective tax rates for these firms. Richter et al. (2009) examine the tax benefits obtained by US firms from political connection created through lobbying. They provide evidence that higher lobbying expenditures are associated with lower effective tax rates. In a cross country analysis, Faccio (2010) provides evidence that politically connected firms have marginally lower tax rates compared to non-connected firms.

### **2.3.3 Political connections and firm performance**

A strand of prior research uses a more direct approach to investigate the effects of political connections on firm performance. Du and Girma (2010) investigate the effects of political connections and firm performance in China. They find that the establishment of political connections increases a firm's prospects of survival. Conditional on survival, politically connected firms exhibit faster growth in employment and productivity. Similarly, Ghita et al. (2009) provide evidence that politically connected firms in Belgium demonstrate higher growth and have a higher likelihood of survival. Using a sample of firms in Germany, Niessen and Ruenzi (2009) find that politically connected firms perform better than unconnected firms in terms of both market based and accounting based performance measures. Niessen and Ruenzi

(2009) also indicate that politicians tend to associate with stable and large firms for reputational reasons.

Jiang (2008) classified the political connections of the CEO or Chairman of firms in China into developed connections and inherited connections.<sup>3</sup> The author finds that the establishment of developed connections leads to an increase in accounting performance but inherited connections lead to a decline in firm performance. According to Jiang (2008), the better performance of firms with developed connections can be attributable to the fact that such connections are developed in a well planned and organised manner. The experience and networks developed are used to generate value for the firms. Boubakri et al. (2009) examine the relationship between political connections and firm performance based on a sample of 234 politically connected firms in 23 countries. They find that the establishment of political connections leads to better performance (measured by changes in return on assets) for politically connected firms compared to non-connected firms. Dombrosvsky (2008) investigates the links between political connections and firm performance using data for all registered firms in Latvia. He finds that the appointment of a politician to the board or the ownership of major shares by politicians leads to a drop in sales by 40%. However, this is followed by an average increase in sales of 75% in the following year. Dombrosvsky (2008) asserts that the establishment of political connections assists

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<sup>3</sup> The former are connections developed through prior service in the government or attendance at Tsinghua University. The latter are inherited through family ties, ethnicity and gender of the CEO and Chairman and the province where they were born.



distressed firms to improve their performance through various political favours received from politicians.

Li et al. (2008) conduct a survey of private firms in China. They find that political connections of private entrepreneurs positively affect their firm's performance (after controlling for other relevant variables). The existence of political connections is more critical to firm performance in regions where market institutions and legal protection are weaker.

Hill et al. (2010) examine the relationship between political connections (established through lobbying) of US firms and their corporate cash holdings. They argue that political connections allow firms to get easier access to capital and stabilise future cash flows. It reduces the need to hold too much cash, which, in turn, reduces the agency and opportunity costs of holding cash. They find that politically connected firms hold less cash compared to unconnected firms.

Using US data, Hillman (2005) use resource dependence theory to examine the association between the existence of a politically connected board of directors and a firm's performance. Consistent with the theory, she finds that the number of politicians on the board is positively correlated with the firm's market based performance (i.e., market capitalisation and market to book ratio) but not with the accounting based performance (i.e., return on sales and return on assets). The correlations are stronger for firms in highly regulated industries compared to those in less regulated industries.

Faccio (2010) asserts that politically connected firms are expected to perform better than unconnected firms because of the benefits acquired through connections. Firms with better performance may become connected in order to maintain their

performance. According to Faccio, it is possible that connected firms may perform poorer compared to unconnected firms. Faccio (2010) suggests that poorly performing firms may become connected in order to get assistance to solve some of their problems. It could also be that firms owned or managed by politicians are inherently poor performers. Using a sample of firms from 47 countries, Faccio (2010) finds that politically connected firms exhibit poorer accounting performance compared to unconnected firms. Faccio (2010) suggests that the poorer performance of politically connected firms may be attributable to the ex-ante underperformance of these firms.

Some studies examine the relationship between political connections and financial performance for newly privatised firms in China (Fan et al. 2007) and across countries (Boubakri et al. 2008) and find that politically connected firms exhibit poor accounting performance compared to unconnected firms. For example, Fan et al. (2007) demonstrate that politically connected firms exhibit poorer earnings growth, sales growth and change in return on sales. Fan et al. (2007) also find that instead of appointing directors with relevant professional backgrounds, politically connected CEOs in China are more likely to appoint their fellow bureaucrats to the board. Fan et al. (2007) and Boubakri et al. (2008) argue that politically connected firms tend to pursue political goals at the expense of value maximisation, which hinders performance improvement. Bertrand et al. (2007) demonstrate that politically connected firms in France create more jobs and build more plants in election years, especially when the firm's operations are located in politically contested areas. Politically connected firms exhibit lower accounting performance than unconnected firms. Firm performance decreases as the employment located in the contested areas increases due to higher labour costs.

Faccio et al. (2006) find that bailed-out firms that are politically connected demonstrate worse financial performance than unconnected firms during the time of the bail-out and two years following the bail-out. Based on their findings, they argue that bail-out of politically connected firms represents a less efficient capital allocation than the bail-out of unconnected firms.

#### **2.3.4 Political connections and access to finance**

Another channel by which the existence of political connections can affect the value of firms is through preferential access to finance. A broad array of literature has examined this issue in different contexts and jurisdictions. Claessens et al. (2008) find that politically connected Brazilian firms that contribute to the campaign of elected candidates increase their bank financing after each election compared to unconnected firms. Based on a sample of firms in Thailand, Charumilind et al. (2006) demonstrate that politically connected firms have greater access to long-term finance compared to unconnected firms. In contrast, Bunkanwanicha and Wiwattanakantang (2009) who measure political connections as the direct involvement of Thailand's business owners in politics by running in the country's election and then holding public office, find no evidence that politically connected firms have greater access to financing. They argue that the direct involvement of the business owners in the regulatory process reduces the importance of political favours that can be obtained through preferential access to finance.

Khwaja and Mian (2005) use loan-level data for firms from Pakistan to examine the association between firms' political connections and their access to finance. Similar to Bunkanwanicha and Wiwattanakantang (2009), Khwaja dan Mian (2005) measure

political connections based on the participation of the firm's director in elections. Khwaja and Mian (2005) find that politically connected firms borrow 45% more than unconnected firms with default rates 50% higher than for unconnected firms. The preferential treatment is provided only by government owned banks and not private banks. Khwaja and Mian (2005) find that the magnitude of political rents received increases with the strength of the politicians on the board. Malesky and Taussig (2009) provide evidence that state-owned commercial banks in Vietnam place greater value on a firm's political connections than performance when making loan decisions. They demonstrate that less profitable politically connected firms have greater access to bank loans than more profitable unconnected firms. Similarly, Chiu and Joh (2004) provide evidence that financially distressed politically connected firms in Korea have preferential access to credit. They suggest that the tendency of banks to loan money to these firms is due to pressure from the government and politicians. Faccio (2010) provides evidence that politically connected firms across 47 countries have higher leverage compared to unconnected firms. She suggests that this reflects preferential access to finance for politically connected firms.

Leuz and Oberholzer-Gee (2006) examine the relationship between political connections and a firm's financing strategies in Indonesia during the regime changes (i.e., from the Suharto regime and his protégé, Habibie, to the new regime, Wahid).<sup>4</sup> They find that the benefits obtained from political connections locally make it unnecessary for politically connected firms to access global capital markets for

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<sup>4</sup> Leuz and Oberholzer-Gee (2006, p.414) assert that President Wahid "treated the Suharto cronies less favourably".

financing. However, once the connections lose their value, these firms are more likely to raise funds from the global capital markets.

Jiang (2009) examines the relationship between political connections and loan contracting in 29 countries. Jiang finds that politically connected firms receive more favourable loan terms such as lower interest rates, more lenient collateral requirements and longer periods of maturity. Jiang argues that banks are more likely to provide loans to politically connected firms as the existence of such connections can mitigate risks associated with the lending.

Hung et al. (2008) investigate the decisions of politically connected firms in China to list in overseas capital markets. They demonstrate that the decision to list partially privatised state owned enterprises is made not because of the firms' need to fund their growth or expand their foreign sales. Instead, the decisions are based on political needs, i.e., to fulfil politicians' private interests and to achieve national political and economic objectives. Using data from the Chinese stock market, Francis et al. (2009) find that newly listed firms with stronger political connections exhibit relatively higher offering prices, lower underpricing and pay lower fees during the process of getting listed on the stock exchange. They conclude that politically connected firms receive significant favours from the government in their process of going public.

Richter (2010) examines the effects of a firm's domestic political connections on their tendency to access global financial markets through cross-listing. Based on a sample of firms from 46 countries, he demonstrates that firms with strong domestic

political connections have better access to global capital markets and the effect is stronger for firms located in countries with weaker property rights.<sup>5</sup> He asserts that, in countries where property rights are weak, foreign investors view the existence of political connections as an implicit property rights protection, which reduces the connected firm's relative risk premiums.

Based on data from 25 countries, Boubakri et al. (2008) find that the average cost of equity capital for politically connected firms is lower than for unconnected firms. They argue that the soft budget constraints generally enjoyed by politically connected firms and the assurance of corporate bailout from the government in the case of financial distress lowers the rate of return required by investors for investing in politically connected firms.

A number of studies provide evidence that government owned banks are generally subject to capture by politicians. Using bank-level data from a sample of banks from emerging markets, Dinc (2005) finds that there is an increase in lending by government owned banks in election years relative to private banks. According to Dinc, the findings demonstrate how government owned banks can be used by politicians to distribute rents to their supporters. Similarly, Sapienza (2004) provides evidence on how government owned banks' decisions are influenced by political connections. Based on a sample of banks in Italy, Sapienza (2004) finds that the interest rates charged by government owned bank depend on the strength of the political party that controls the bank. A firm borrowing money from a bank in the area where the political

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<sup>5</sup> Richter (2010) suggests that the strength of the property rights institutions is negatively related to the risk of expropriation by the state other participants in the economy.



party that controls the bank is stronger (weaker) are charged a lower (higher) interest rate.

### **2.3.5 Political connections, accounting quality and corporate governance**

A group of studies investigates the relationship between political connections and a broad array of accounting and corporate governance variables including auditing. A number of studies investigate political connections in the context of accounting. Chaney et al. (2011) investigate the quality of earnings reported by firms across 19 countries. They provide evidence that politically connected firms exhibit poorer earnings quality compared to similar non-connected firms. They assert that the protection provided by politicians ensures that the low quality accounting disclosure is not penalised by the market. This, in turn, lessens the initiatives of the politically connected firm's management to accurately portray the firm's accruals. In addition, Chaney et al. (2011) find that lower earnings quality is associated with a higher cost of debt only for non-connected firms. It supports their argument that politically connected firms do not face the same negative consequences of poor information quality as their non-connected peers.

Using a sample of US firms, Correia (2010) examines the association between political connections and accounting quality and misreporting incidents. The strength of political connections is based on the firm's political expenditure, i.e., campaign contributions made by the firm and its top executives as well as the firm's lobbying expenditure. She demonstrates that the amount of a firm's political expenditure is negatively associated with accounting quality. Firms with higher political expenditure have lower accounting quality. These firms make more political contributions during

the misreporting period and the contributions are mainly targeted to the Congressional Committees with stronger ties to the Securities and Exchange Commission (SEC).

How et al. (2009) investigate the effect of political connections on earnings predictability. Using Malaysian data, they demonstrate that analysts' earnings forecast error is higher for politically connected firms compared to unconnected firms. They assert that political connections increase earnings opacity, hence, making it difficult for analysts to make more accurate forecasts. Based on firm-level data from 17 countries, Chen et al. (2010) examine the relationship between the existence of political connections in firms and the earnings forecasts made by financial analysts. They demonstrate that analysts' earnings forecasts are less accurate for politically connected firms compared to unconnected firms. They argue that although political favours received from politicians may help firms to smooth their earnings, making them more predictable, the distortion caused by political favouritism makes it more difficult for analysts to accurately forecast earnings for those firms. Chen et al. (2010) also find that larger forecast error is more prevalent in countries with higher levels of corruption.

Another group of studies examines firms' political connections in the context of corporate governance, particularly auditing. Based on a sample of Chinese listed firms, Wang et al. (2008) investigate the effects of political connections, developed through government share ownership, on auditor choice. They demonstrate that politically connected firms are more likely to appoint small local auditors. According to the authors, the special treatment received from the government and government owned banks, the likelihood of being bailed out by the government in the case of potential

corporate failure and the likelihood of using their political power to facilitate collusion, are among the potential reasons that explain the tendency of politically connected firms to hire small local auditors.

Using a sample of privatised firms in 32 countries, Guedhami et al. (2009) provide evidence that auditor choice is influenced by a firm's political connections. They find that privatised firms with greater foreign (state) ownership are more (less) likely to appoint a Big 4 auditor. This relationship strengthens when country-level governance institutions are relatively poor. Guedhami et al. (2010) conduct similar research, but use a different measure of political connections. This research defines political connections according to Faccio (2006), i.e., the existence of a politically connected shareholder or board member. Based on data from 47 countries, Guedhami et al. (2010) find that politically connected firms are more likely to appoint a Big 4 auditor compared to non-connected firms. They attribute this result to the tendency of a politically connected firm's management to enhance accounting transparency in order to assure the outside investors that the existence of political connections does not lead to misallocation of the firm's resources. In line with Guedhami et al. (2009), Guedhami et al. (2010) also find that, as the level of state ownership increases, the demand for a Big 4 auditor decreases.

Gul (2006) finds that as the result of the Asian financial crisis, the increase in audit effort and audit fees for politically connected firms in Malaysia is higher than for non-politically connected firms. He argues that this is due to a perceived higher risk of financial statement misstatements for politically connected firms. Gul (2006) also demonstrates that the introduction of capital controls by the government leads to a decline in audit fees for firms with political connections. He argues that the capital

controls were introduced to assist politically connected firms rebound from the crisis, which, in turn, reduces the risks of financial statement misstatement.

Bliss et al. (2008) extend Gul (2006) to examine whether the introduction of the Malaysian Code on Corporate Governance reduces the risk associated with political connections and cronyism, hence reducing audit effort and audit fees. They found that the introduction of the code did not mitigate the risks associated with political connections and cronyism. In addition, politically connected firms with CEO duality are perceived by audit firms as having higher risk compared to non-politically connected firms. Based on a sample of firms in Malaysia during 1999-2003, Wahab et al. (2009) find that politically connected firms pay higher audit fees compared to non-politically connected firms. They attribute the existence of audit fee premiums to the greater perceived risk inherent in politically connected firms due to poor corporate governance and agency conflicts. This is consistent with Wahab et al. (2007), who find that there is a negative effect of political connections on a firm's corporate governance in Malaysia. In addition, Wahab and Rahman (2009) demonstrate that the political connections of firms in Malaysia reduce the effectiveness of institutional investors as a monitoring mechanism for director remuneration.

Using Malaysian data, Rahman et al. (2010) investigate the effect of a client's political connections on auditor independence when the auditor provides audit and non-audit services to the client. Consistent with Wahab et al. (2009), they provide evidence that politically connected firm exhibit higher levels of audit fees compared to unconnected firms. Connected firms also have higher non-audit fees. The relationship between audit fees and non-audit fees is stronger for politically connected firms. Rahman et al. (2010) also find a negative relation between political connections and

the likelihood of auditors issuing a modified opinion. They assert that the existence of political connections could jeopardise auditor independence, both in fact and in appearance.

In another audit related study, Yu and Yu (forthcoming) examine the links between political connections and fraud detection. Based on sample of 239 large frauds detected in the US between 1996 and 2004<sup>6</sup>, they investigate how political connections created through corporate lobbying expenditure affect fraud detection. Yu and Yu divide the sample of fraudulent firms into politically connected and non-politically connected. They find that politically connected firms have a higher probability of avoiding fraud detection. Fraudulent politically connected firms manage to avoid fraud detection 117 days longer than unconnected firms. The fraud committed by politically connected firms is 38% less likely to be detected by regulators compared to the fraud committed by unconnected firms. These fraudulent firms increase the strength of their political connections by increasing their lobbying expenses after they have committed fraud. They also find that the delay in detection defers negative market reactions, hence providing an opportunity for managers to dispose of their shares.

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<sup>6</sup> Yu and Yu (forthcoming) obtain their sample of fraudulent companies from Dyck, Morse and Zingales (2006a, 2006b) who collected a sample of firms subject to lawsuits from the Stanford Class Action Clearinghouse.

### **2.3.6 Political Connections in Malaysia**

In this section, the origin of political connections in Malaysia is discussed. The section also discusses the nature of ruling party connections and opposition party connections in Malaysia.

#### **2.3.6.1 Origin of Political Connection in Malaysia**

Political connections have been part and parcel of the Malaysian political economy for decades. There are two main factors that contribute to the prevalence of political connections in Malaysia. The first factor is related to the introduction of the New Economic Policy (NEP) and the second factor is related to the existence of informal ties between the country's top political leaders with Malaysian businessmen from various backgrounds (e.g., Gul, 2006 and Adhikari et al., 2006). These two factors are discussed in details in this section.

The introduction of the New Economic Policy (NEP) must be seen in light of Malaysian pre-independence and its colonisation history. Malaysia is made up of three main ethnic groups where the largest ethnic group is the indigenous Bumiputeras (or "sons of the soil") who are predominantly Malay, followed by the Chinese and the Indians. The country gained independence in 1957 after the British handed over the administration of the country to the Alliance Party that consists of three component parties. The largest party in the alliance is the United Malays National Organisation (UMNO), which represents the interest of the Bumiputeras. The Malaysian Chinese Association (MCA), which represents the interest of the Chinese, is the second largest component party followed by the Malaysian Indian Congress (MIC), which represents the interests of the Indians. The Alliance Party is later known as the National Front or



Barisan Nasional and expanded to include a number of other parties in the peninsular, Sabah and Sarawak. UMNO, however, remains the dominant party in the coalition.

The British policy of divide and rule during the colonisation period resulted in a majority of Bumiputeras remaining as peasants in the rural areas, the Indians working in the semi rural plantations and the Chinese involved in the tin mining and commercial sectors in the urban areas after independence was granted (Gomez and Jomo, 1997). In the first decade following colonisation, the Bumiputeras' participation in the country's economy was minimal and the income inequality among the ethnic groups, particularly the Bumiputeras and the Chinese increased significantly. In 1969, Bumiputeras' ownership in the corporate sector is a mere 1.5 percent compared to 23.7 percent for other Malaysians (i.e., the Chinese and the Indians), while the remaining was mainly owned by the foreigners (Malaysia, 1996). The inequality between the races combined with intense racial sentiments after the general election on 10 May 1969 are among the factors that contributed to ethnic clashes and violent riots on 13 May 1969, mainly between the majority Malay and the Chinese.

In response to the racial tensions and the underlying ethnic inequality, the Malaysian government introduced New Economic Policy (NEP) in 1971. The main aim of the NEP is to eradicate poverty and to restructure the economy, hence reduce and eliminate interethnic economic disparities.<sup>7</sup> The NEP was developed to give effect to the special rights and privileges of the Bumiputeras as stated in the Malaysian Constitution by initiating various protective policies (Mehmet, 1986). As a party that

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<sup>7</sup> Refer to Faaland, Parkinson and Saniman (1990) for a more detailed discussion and review of the NEP.

represents the Bumiputeras and a dominant party in the coalition government, UMNO plays a crucial part in the development of the NEP. As suggested by Faaland et al. (1990, p.179), "as far as UMNO is concerned, the NEP is equated with the party".

One of the main focuses of the NEP is to increase Bumiputeras' participation in the economy. The government set a target that Bumiputeras' ownership in the corporate sector must reach at least 30 per cent of the total ownership in the corporate sector by 1990. Given that, in 1971, the corporate shares held by Bumiputeras stood at only 4.3 percent<sup>8</sup> and the economic resources available to Bumiputeras were very limited, the Malaysian government decided to increase its intervention in the country's economy as part of an effort to ensure the achievement of the NEP's objectives (Malaysia, 1981; Geoffrey and Stafford, 1997). This included the introduction of various initiatives, policies and legislations as well as the involvement of the government in the corporate sector (Gomez, 2003; Gomez and Jomo, 1997). A number of trust agencies were established by the government. These trust agencies play crucial roles in acquiring shares in the capital market on behalf of the Bumiputeras and hold them in trust until the Bumiputeras are able to purchase the shares (Teh, 2002).<sup>9</sup>

In an effort to increase the participation of the Bumiputeras in corporate management, the Bumiputeras are given priority by the government to fill up the board of directors and senior management positions in the trust agencies and their

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<sup>8</sup> 2.6 percent and of the shares are held by individual bumiputeras while another 1.7 percent are held by the government trust agencies on behalf of the bumiputeras.

<sup>9</sup> These include agencies such as Permodalan Nasional Berhad (PNB), Perbadanan Nasional Berhad (PERNAS), Lembaga Tabung Haji and Urban Development Authority (UDA).

controlled companies. This indirectly creates a patronage system where the Bumiputeras rely on the government for the opportunity to serve in those organisations in return for support to the government. In addition, the Malaysian government also introduced the Foreign Investment Committee (FIC) in 1974 and the Industrial Coordination Act in 1975 which require every firm listed on Bursa Malaysia<sup>10</sup> to have a minimum 30 percent of its equity allocated to the Bumiputeras trust agencies or Bumiputeras companies/individuals (Yasuda, 1991; FIC, 1999; FIC 2008).<sup>11</sup>

In 1983, two years after he assumed office, the then Malaysian Prime Minister, Dr. Mahathir announced a new approach to national development through a privatisation program. The aim of the program was to increase participation of the private sector in the economy. The government was of the view that participation of the Bumiputeras in the privatisation programme is vital in ensuring the achievement of NEP objectives. The appointment of Daim Zainuddin, the then UMNO treasurer, as a finance minister in 1984, lead to a more rapid privatisation program where the scope of the privatisation was broadened to include the complete or partial sale of government-owned companies, private financing of various constructions projects, management buy-outs and privatisation of public services (Wain, 2009). Given that the UMNO plays crucial roles in the design and the development of the NEP, the party leaders have a significant influence on implementation of the policy, including the privatisation program. Several authors (Wain, 2009; Gomez, 2003; Gomez and Jomo,

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<sup>10</sup> Formerly known as Kuala Lumpur Stock Exchange (KLSE).

<sup>11</sup> The Industry Coordination Act 1975 was temporarily abandoned during the global economic crisis in the mid 1980s (Geoffrey and Stafford, 1997).

1997; Geoffrey and Stafford, 1997) argue that the main beneficiaries of the privatisation program are those politically connected to UMNO leaders. The authors assert that politically connected businessmen acquire government-owned assets at a discounted price through government guaranteed soft loans (Wain, 2009; Gomez and Jomo, 1997). Gomez and Jomo (1997) provide a number of examples of the influence of political connections in the government privatisation program.

According to Wain (2009, p. 103), Dr Mahathir defends the creation of Bumiputeras corporate empires through personal contacts with the UMNO leaders as he viewed the Bumiputera businessmen selected to receive favours from the government are "more capable of using state patronage resources than the broad mass of Bumiputeras". The privatisation program also led to the creation of a number of government-linked companies where the Malaysian government is the controlling shareholder (mainly through the government investment holding arm, Khazanah Holdings). Being a controlling shareholder, the politicians and the government that are currently in power can control the decisions made by these companies, including those related to the appointment of the board of directors and senior management and the awarding of various major contracts. This creates an opportunity for an effective patronage system where the politicians control the companies' decisions in relation to the appointment of the board and senior management as well as the allocation of contracts in favour of those closely connected to them in return for economic and financial support.

Apart from the privatisation program, Dr Mahathir also embarked on fiscal expansion by increasing the public sector expenditures during his tenure as Prime Minister (Wain, 2009; Gomez and Jomo, 1997). Increases in government spending led

to an increase in the government procurement contracts available to the private sector. Given that the Bumiputeras lack exposure and business networks, in the spirit of NEP, substantial portions of the government procurement contracts are allocated to Bumiputeras' companies (Geoffrey and Stafford, 1997). It is argued that the allocations of government procurement contracts to Bumiputeras' companies are not based solely on their capability and merit, but instead on their political connections to the political leaders, particularly from the UMNO (Gomez, 2009; Wain, 2009; Gomez, 2003; Gomez and Jomo, 1997; Geoffrey and Stafford, 1997). In some cases, it is argued that Bumiputeras businessmen, who are politically connected to the political leaders in power, manage to secure government contracts although they do not have the capacity and capability to deliver on the contracts. These contracts are, in turn, sub-contracted to Chinese businessmen (Gomez, 2009; Gomez, 2003).

During the Malaysian share market boom from the late 1980s until the late 1990s, the number of initial public offerings (IPOs) in the Malaysian share market increased dramatically. The government requires that every new firm listed on the Bursa Malaysia must have at least 30 percent of their shares held by the Bumiputeras. The 30 percent equity requirement can be fulfilled either by having Bumiputeras shareholders holding 30 percent of the firm's paid up capital before the listing or by issuing the 30 percent Bumiputeras portion of the paid up capital as part of the initial public offering (IPO) (FIC, 2008; Securities Commission of Malaysia (SC), 2008). For the latter option, the Ministry of International Trade and Industry (MITI) is responsible for identifying suitable Bumiputeras' owned companies to acquire the shares. Given that most of the companies seek to be listed do not have a Bumiputeras' holding of at least 30 percent prior to listing, the Ministry of International Trade and Industry takes

responsibility to find suitable Bumiputeras' companies to acquire the shares. With an active and bullish share market during that time, "those who are allocated shares, usually sold at a huge discount, are certain of a windfall when the companies are listed" as the newly companies received huge premiums when they made their debut on Bursa Malaysia (Chin 1996, p. 401). The share allocation, in turn, has been used by a number of UMNO politicians as a vehicle for political patronage (Perkins and Woo, 2000). Influential UMNO politicians are alleged to use the share allocation to develop a power base in the party.<sup>12</sup>

Overall, the patronage system that is widespread in Malaysia's political economy, particularly in the implementation of the NEP, is one of the main factors that contributes to the prevalence of political connections in the country. The patronage system has been used as a vehicle to build a strong base in the party as well as to ensure a successful implementation of the NEP. Gomez (2005, p. 38) argues that "when they resorted to selective patronage, Mr. Anwar did so primarily to secure the premiership, while Dr. Mahathir was driven by his longing to accomplish his economic goals". Guided by the perception that those politically connected to influential political leaders in the government receive various favours and benefits from the government and the politicians, many Bumiputeras seek to actively participate in UMNO politics. They view involvement in politics as a quick means to obtain various business

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<sup>12</sup> During the UMNO General Assembly in 1998, a comprehensive list of Bumiputeras who received share allocations was released and the list indicates that those who are connected to the then Deputy Prime Minister, Anwar Ibrahim and his protégé, Zahid Hamidi are among those who benefited handsomely (Felker, 1999).



opportunities, favourable treatments and other rents from the government (Gomez and Jomo, 1997; Teh 2002). The existence of political patronage, in turn, “perpetuates rent-seeking activities by those seeking to induce government decision-makers to allocate various state rents in their favour in return for economic and political support” (Gomez and Jomo, 1997, p. 6).

Apart from the introduction of the NEP, the origin of political connections in Malaysia is also associated with the existence of informal ties and personal relationships between businessmen from various ethnics with the country’s top political leaders, particularly the then Prime Minister, Dr Mahathir, the then Deputy Prime Minister, Anwar Ibrahim, and Daim Zainuddin, Dr Mahathir’s close confidant who was appointed finance minister twice during Mahathir’s 22 year tenure as Prime Minister. During the government’s privatisation program, for example, a number of authors argue that the privatisation not only benefited the Bumiputeras but also the non-Bumiputeras that have close connections with Dr Mahathir, Anwar Ibrahim and Daim Zainudin (Wain, 2009; Gomez, 2009; Gomez and Jomo, 1997; Geoffrey and Stafford, 1997).

Informal ties between businessmen and the political leaders are established through various means. For example, Ishak Ismail, one of the prominent figures in the Malaysian corporate world during the 1990s, once served as a secretary in the Permatang Pauh UMNO Division that was headed by Anwar (Gomez and Jomo, 1997, p. 125). A number of other prominent businessmen during that time, such as Yahya Ahmad, Kamaruddin Jaffar and Kamaruddin Mohamad Noor are Anwar’s schoolmates at the Malay College Kuala Kangsar (Gomez and Jomo, 1997, p. 125). Mohamed Sarit Yusoh and Nasaruddin Jalil are Anwar’s former political secretaries, who turned into

prominent business figures (Gomez and Jomo, 1997, p. 125). Ananda Krishnan, who is now one of the richest men in Malaysia, is reported to be a close friend of Dr Mahathir (Gomez and Jomo, 1997, p. 160). Names such as Tajuddin Ramli, Halim Saad and Wan Azmi Wan Hamzah are known to be close associates of Daim Zainuddin, who trained them in business long before Daim accepted the offer by Dr Mahathir to be appointed as a finance minister in 1984 (Gomez and Jomo, 1997). The existence of personal relationships allows a more direct distribution of various favours and benefits to the closely connected individuals in return for economic and political support.

#### **2.3.6.2 Ruling Party Connections and Opposition Party Connections**

In order to describe the types of political connections in Malaysia, it is crucial that the country's current political environment is taken into consideration. Ever since becoming independent, the National Front or Barisan Nasional (formerly known as the Alliance Party) won the majority of the federal parliament seats in every single general election in the country's history. The best performance by the opposition parties before the Malaysian 12<sup>th</sup> general election in March 2008 was in the 10<sup>th</sup> general election conducted in 1999, i.e., a year after the dismissal of the then Deputy Prime Minister Anwar Ibrahim from office. After his dismissal from the Deputy Prime Minister post, Anwar became an icon for the opposition parties. During the 12<sup>th</sup> general election in 2008, Anwar led an informal opposition pact, called the People's Pact or Pakatan Rakyat, which consisted of the Pan-Malaysian Islamic Party (PAS), the People's Justice Party (PKR) and the Democratic Action Party (DAP). Although Barisan Nasional won the majority of the seats in federal parliament, the party lost control in five states, i.e., Selangor, Perak, Penang and Kedah (in addition to another state, Kelantan, that

had been under control by the PAS since 1990) (Mokhtar, 2008).<sup>13</sup> Barisan Nasional managed to retain control over another eight states in Malaysia.

Given this scenario, a firm's political connections in Malaysia can be viewed from two different perspectives. Looking from the federal or national level perspective, the Barisan Nasional is considered as the ruling party at the federal level while Pakatan Rakyat is the opposition party. On the other hand, looking from the state based perspective, in the states controlled by Pakatan Rakyat (Barisan Nasional), Barisan Nasional (Pakatan Rakyat) is considered to be the opposition party whereas Pakatan Rakyat (Barisan Nasional) is the ruling party.

In this thesis, a firm's political connections are viewed from the national perspective. In the discussion about the origin of political connections in Malaysia, the favours and benefits received by the politically connected firms are due to the fact that: (1) they are connected to the political party that is currently the dominant party in the federal coalition government; (2) they are connected the political leaders who are currently serving in the federal government. Hence, firms with such connections are considered as ruling party connected firms. Firms that are politically connected to the opposition party at the federal level and/or top opposition leaders at the federal level are considered as firms with opposition party connections.

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<sup>13</sup> Perak later fell under BN control after three of its State Assembly members from the Pakatan Rakyat abandoned the coalition to become independent members of the State Assembly.

### 2.3.7 Section Summary

This subsection summarises the political connections discussed in Section 2.3. Political connections are defined in the literature in various ways. A personal or family relationship between a major shareholder or top officer with top political leaders or current/former head of state (such as Prime Minister or President) appear in the literature as one of the most common measures of political connections. Another measure used frequently in the literature is when a major shareholder or top officer such as board of directors is a current/former member of parliament/senator or current/former minister. As such, the appointment of a member to a board of directors who has personal connections to the top political leaders currently in power or directors who are former members of parliament demonstrate the existence of political connections in firms.

According to one stream of research summarised in this chapter, investors perceive political connections as a factor that can create value to firms. This is based on market reactions to particular events that may have an impact on politically connected firms. The literature indicates that positive perceptions of political connections are prevalent across countries. The literature also demonstrates that connections to different individuals or political parties bring different value to firms. Although the results are mixed, the literature, taken as a whole, demonstrates that firms connected to individuals or political parties that are in a position to provide favours to politically connected firms are viewed more favourably by investors. These firms exhibit positive market reactions in response to news about the establishment or enhancement of political connections.

It also appears that the market views the loss of political connections or potential loss of such connections as detrimental to a firm's value. The loss of such connections implies that politically connected firms are not in a position to receive favours from the politicians or the government. The research reviewed in this section also demonstrates that the introduction of various government policies can have different impacts on firms, depending on their connections to government. The introduction of new government policies or changes in policies has a positive impact on the value of firms that are connected to the top political leaders in power or to the government in general.

Another stream of literature demonstrates the relationship between a firm's political connections and the favours received from government. These studies, taken as a whole, demonstrate that firms connected to the government in power are more likely to be bailed out by the government, are more likely to secure higher procurement contracts from the government and tend to have lower effective tax rates compared to unconnected firms. From the literature that examines the relationship between political connections and firm performance, it appears that the existence of political connections can have both positive and negative effects on a firm's performance. However, taken as whole, the favours received by firms through political connections generally lead to better performance. The poor performance of politically connected firms can be attributed to a number of reasons: (1) the costs associated with the rent seeking activities by the politically connected firms are higher than the benefits received through political connections; (2) politically connected firms tend to pursue political goals instead of value maximisation for the firms; and (3) politically connected firms are inherently poor performers.

The literature also indicates that politically connected firms receive preferential access to finance compared to unconnected firms. Politically connected firms: (1) generally demonstrate higher levels of borrowing following the election victory of politicians or political parties connected to them; (2) receive more favourable credit assessments and are subject to less stringent credit requirements from banks; (3) are given more favourable loan terms such as lower interest rates and longer maturity; and (4) are less reliant on finance from global capital markets. According to the research discussed, political connections appear to be associated with a broad array of accounting and corporate governance variables. The literature demonstrates that politically connected firms tend to have lower accounting quality.

In addition, earnings for politically connected firms are less predictable compared to the earnings of unconnected firms, due to the distortion caused by the favours acquired through political connections. A group of studies that examines the links between political connections and audit fees provides evidence that a firm's political connections influence auditors' assessments of risks, which, in turn, affect audit effort and audit fees. In terms of fraud detection, prior research provides evidence that the existence of political connections affects the timing of fraud detection by the relevant authorities.

The final part of this section discusses the origin of political connections in Malaysia and the nature of ruling party connections and opposition party connections in the context of Malaysian political economy.



## **2.4 Summary**

This chapter discusses prior research relevant to the current study and the hypotheses development. The chapter begins with a discussion on research dependence theory (RDT), which is used to explain a firm's decision to appoint politically connected individual as a member of a board of directors. Then, prior research relevant to political connections is reviewed and summarised in Section 2.3. The review focuses on definitions of political connections, various benefits associated with political connections and political connections in the context of accounting quality and corporate governance. The section then discusses political connections in Malaysia. The development of the relevant hypotheses is discussed in the next chapter.

# CHAPTER 3

## Hypotheses Development

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### 3.1 Introduction

This chapter outlines the development of the hypotheses tested in this thesis. In Section 3.2, the relationships between gaining an understanding of a client's business and its environment and business risk assessment are discussed. This is followed by the development of the relevant hypotheses. Section 3.3 explains the relationship between business risk assessment and the assessment of the risks of material misstatement (due to error and fraud) and audit risk. It also discusses the link between audit risk, audit effort and audit fee. Based on this, the relevant hypotheses are developed. Section 3.4 summarises the chapter.

### 3.2 Understanding the client and its environment and business risk assessment

In the late 1990s, many large accounting firms throughout the world introduced a new audit methodology that emphasises obtaining a thorough understanding of the client entity and its external environment and the use of that understanding to assess the client's business risk and the risks of material misstatement in the financial statements (Flint, Fraser and Hatherly, 2008; Eilifsen, Knechel and Wallage, 2001; Lemon, Tatum and Turley, 2000; Winograd, Gerson and Berlin, 2000; Bell, Marrs, Solomon and Thomas, 1997). In the auditing literature, this audit approach is referred to as a "business risk audit" (Lemon et al., 2000; Flint et al., 2008) or "strategic systems audit" (Bell et al., 1997; Bell, Peecher and Solomon, 2005).

and Peecher, Schwartz and Solomon, 2007).<sup>14</sup> In this thesis, this audit approach is referred to as a business risk audit approach.

As a result of the business risk audit approach, standard setters introduced a new auditing standard, ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.<sup>15</sup> The standard gives particular importance to the need to obtain an understanding of the client and its environment (including its internal control) and to use that understanding in assessing the client's business risk and the risks of material misstatement. ISA 315.4(b) defines business risk as "a risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies". Business risk relates closely to a firm's external environment. Any development in the external environment that has the potential to negatively affect the achievement of a firm's business objectives and strategies constitutes a business risk. On the other hand, any development in the external environment that enhances the likelihood of a firm achieving its business objectives and strategies is considered as a factor that decreases the firm's business risk.

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<sup>14</sup> Refer to Bell et al. (1997), Lemon et al. (2000), Bell et al. (2005), Knechel (2007), Robson, Humphrey, Khalifa and Jones (2007), Peecher et al. (2007) and Curtis and Turley (2007) for a more detailed debate and explanation about the development and the motivations behind the introduction of this audit approach.

<sup>15</sup> ISA 315 was introduced for the first time in 2004 and named as "*Understanding the Entity and Its Environment*". The latest version of ISA 315 was issued in December 2009 and named as "*Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*".

Gaining an understanding of the client and its environment is a crucial step in assessing the client's business risk (Arens, Best, Shailer, Fiedler, Elder and Beasley, 2010; Gay and Simnett, 2010). Lack of such an understanding may have detrimental effects on the audit. For example, in a fraud case involving Lincoln Savings and Loan (LSL), Erickson, Mayhew and Felix (2000) assert that the most significant deficiency in the audit of LSL was the failure of the auditor to obtain and utilise the knowledge about the entity and its industry and the economic forces that influence LSL. The authors suggest that "understanding a client's business is an effective audit procedure that provides reliable audit evidence in both the absence and presence of management fraud" (Erickson et al., 2000, p.168).

Gaining an understanding of the client and its environment can be acquired by various means. For example, Bell et al. (1997) advocate the use of strategic analysis and business process analysis while Gay and Simnett (2010) suggest the use of strategic management techniques such as SWOT analysis, PEST analysis, the value chain approach and evaluating non-financial performance measures.<sup>16</sup> One of the common themes in all of the techniques is the need to consider the client's internal and external environments and to develop a comprehensive understanding of the linkages between the two environments.

By using SWOT analysis, for example, auditors can develop an understanding of how the client utilised its internal strengths (S) to take advantage of the opportunities (O) available in the external environment and to mitigate potential threats (T) that

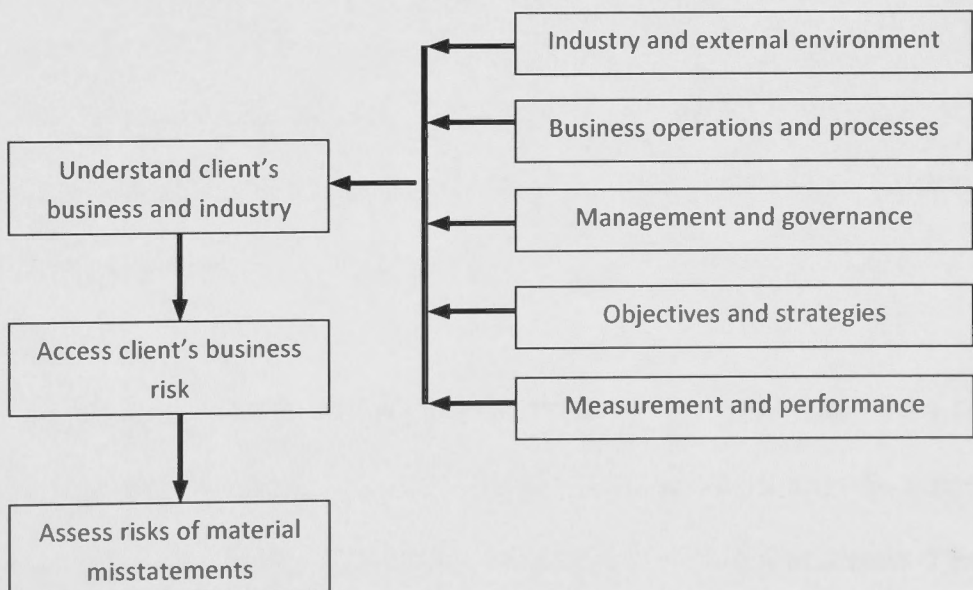
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<sup>16</sup> Refer to Bell et al. (1997) and Gay and Simnett (2010) for a discussion about the various means used to acquire an understanding of a client and its environment.

exist in the external environment. During the analysis, auditors obtain a deep understanding of the client's strategic systems that are comprised of the client's organisation and the network of activities as well as interrelationships with other economic agents (Bell and Solomon, 2002). The acquired knowledge allows auditors to develop a holistic picture of the client's entity and its relationship with the external environment.

There are a lot of factors that auditors need to consider when obtaining an understanding of a client and its environment. Arens et al. (2010) summarise some of the factors and demonstrate the link between these factors and the assessment of a client's business risk (refer to Exhibit 3.1).

**Exhibit 3.1: Understanding the client's business and industry, assessment of business risk and risks of material misstatements (Arens et al., 2010, p. 225)**



According to ISA 315.11, the auditor must obtain an understanding of, among other issues: (a) relevant industry, regulatory and other external factors; (b) the nature of the entity, including its operations, its ownership and governance structures, the types of investments that the entity is making, the way that the entity is structured and how it is financed; and (c) the entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. ISA 315.A17-A41 provide some examples and explanations of factors that need to be considered by auditors.

ISA 315.A19 states that regulatory factors include the political environment where auditors may need to consider "government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs)". Some of the government policies may have negative impacts on the client's operations, which, in turn, increases the client's business risk. For example, government monetary policy decisions to increase interest rates can have a detrimental impact on firms that rely on bank loans to finance their operations. On the other hand, other policies such as a government aid program may have a positive impact on the client and, hence, reduce its business risk.

According to research dependence theory (RDT), the relationship that a firm (through its board of directors) establishes with the important elements in the external environment (including with government) is crucial for its survival and success. This is especially important when one of the firm's critical success factors is closely related to: (1) government policies and decisions; and (2) the likelihood of receiving benefits and favours from the government.



The studies reviewed in the previous chapter provide evidence that firms closely connected to government are in a position to receive favours and benefits from politicians and the government. The favours and benefits received by ruling party connected firms can take many forms, such as a higher likelihood of procuring contracts from the government (Goldman et al., 2008; Bunkanwanicha and Wiwattanakantang, 2009), easier access to finance and lower cost of capital (e.g., Malesky and Taussig, 2009; Claessens et al., 2008; Charumilind et al., 2006; Khwaja and Mian, 2005; Kang 2002), various tax benefits (Gupta and Swenson, 2003; Adhikari et al., 2006; Ritcher, 2010), a higher likelihood of being bailed out (Faccio et al., 2006) and preferential treatment in obtaining relevant licences and necessary approvals (Agrawal and Knoeber, 2001; Du and Girma, 2010).

In contrast, a firm that is connected to opposition leaders or the opposition party is not likely to receive special favours and benefits from politicians or the government in power. In fact, prior research provides evidence that being opposition party connected can have a detrimental effect on a firm's value (Shon, 2010; Makaew, 2010; Nelvin, 2010; Goldman et al., 2009; Hsieh, Miguel, Ortega and Rodriguez, 2009; Goldman et al., 2008; Knight, 2007; Jayachandran, 2006; Chong, Liu and Tan, 2006; Johnson and Mitton, 2003). Goldman et al. (2009) provide evidence that the loss by the Democratic Party in the 2000 presidential election lead to a negative cumulative abnormal return for firms connected to the Democrats. Johnson and Mitton (2003) find that the introduction of capital controls by the Malaysian government during the Asian economic crisis in 1998 resulted in an increase in the market value of firms connected to Prime Minister Mahathir but not for firms connected to the sacked Deputy Prime Minister, Anwar Ibrahim. They assert that firms connected to Anwar

Ibrahim are either subsequently taken over by Mahathir's connected firms or switch their support to Mahathir. Chong et al. (2006) provide evidence that a forced bank merger scheme introduced by the government in response to the Asian financial crisis negatively affected banks connected to the sacked Deputy Prime Minister, Anwar Ibrahim. These banks lost significant value during the merger period, whereas ruling party connected banks were not significantly affected.

Makaew (2010) conducts a similar study in Thailand surrounding the introduction of capital controls by the Thai government on 19 December 2006 and its subsequent abandonment the next day. He finds that firms connected to former Prime Minister Thaksin reacted negatively to the introduction of the capital controls and reacted positively to the subsequent abandonment. Makaew (2010, p.18) concludes that "the market views Thai capital control as a way to punish firms that are connected to the opponent of the people in power". Nelvin (2010) finds the value of firms connected to Thailand's cabinet members are negatively affected subsequent to the 2006 military coup in Thailand (where the country's parliament was dissolved and the ruling party was banned).

Jayachandran (2006, p.400) asserts that the existence of opposition party connections through political donations to the opposition could affect politicians' behaviour where they may "retaliate against firms that donate to their opponents". At an individual level, Hsieh et al. (2009) use Venezuelan data and provide evidence that those individuals identified by the Chavez regime as opponents received negative treatment from the government. The opponents experienced a drop in earnings and employment rates.

Hence, from the resource dependence perspective, in an economic environment where all firms in an industry are competing for scarce resources, a firm with ruling party connections is in a better position to secure the scarce resources compared to a firm with opposition party connections. Through its political connections, ruling party connected firms are more likely to secure resources such as government contracts (Goldman et al., 2008) and bank loans (Boubakri et al., 2008; Claessens et al., 2008; Charumilind et al., 2006; Khwaja and Mian, 2005; Li et al., 2008). A firm with opposition party connections is not in a position to receive special favours and benefits from politicians or the government that are currently in power (Funston, 2000). Instead, opposition party connected firms are prone to negative treatment from them (Makaew, 2010; Jayachandran, 2006; Chong et al. 2006; Johnson and Mitton, 2003). As a firm's ability to secure scarce resources from the external environment is critical to the firm's success, ruling party connected firms are more likely to achieve their business objectives compared to opposition party connected firms, *ceteris paribus*.

Consider the following scenario. A construction firm is operating in a highly competitive construction industry during the global economic crisis where private sector companies decide to put on hold many construction projects planned until the economic conditions improve. In order to stimulate the economy, the government introduces economic stimulus initiatives including significant spending for the construction of various public infrastructures and facilities. Although private banks tighten their financing facilities, the government, through government owned banks and other banks linked to the government, increase the credit available to selected firms. In this scenario, although all firms in the industry are equally affected by the

competition, declining demand and tightening of credit facilities by private banks, a firm that is politically connected to the government in power should have a competitive advantage over opposition party connected firm or unconnected firm. In addition, ruling party connected firms are more likely to be awarded government construction contracts from the economic stimulus package by the government and more likely to get preferential access to finance from government owned banks or banks linked to the government. This increases the likelihood of a ruling party connected firm successfully executing its business strategies and achieving its business objectives.

Therefore, auditors in the ruling party connections group are more likely to identify political connections as a factor that decreases a client's business risk. In contrast, auditors in the opposition party connections group are more likely to identify political connections as a factor that increases a client's business risk. The reasoning leads to the following hypothesis:

H1: The existence of political connections is more likely to be identified as a factor that decreases (increases) a client's business risk for a client with ruling party (opposition party) connections compared to a client with opposition party (ruling party) connections.

Although ruling party connected firms are in a position to receive various favours and benefits from politicians and the government currently in power, these favours and benefits do not come without costs and drawbacks. Firms with ruling party connections tend to rely on political connections for their growth, expansion and

survival (Gomez, 2005; Gomez and Jomo, 1997; Johnson and Mitton, 2003). The benefits and favours from political connections are transferred from the patrons to the ruling party connected firms by various means, including via related party transactions (Gomez and Jomo, 1997; Chen et al., 2011; Berkman et al., forthcoming). The tendency to rely on political connections for their growth, expansion and survival means that management of these firms is under no pressure to innovate and improve their productivity and efficiency. This contributes to the inherent inefficiency associated with ruling party connected firms (Gomez, 2005; Gomez and Jomo, 1997; Johnson and Mitton, 2003).

Given that growth and expansion are built around the political connections instead of the firm's own strengths<sup>17</sup>, ruling party connected firms are less resistant to sudden changes in the external environment, such as changes in the economy (Gul, 2006; Gomez, 2003; Johnson and Mitton, 2003). This becomes more apparent when changes in the external environment affect the ability of the firm's patrons (i.e., the politicians or the government that they are connected with) to provide the necessary assistance to the firm, such as the inability of the government to assist ruling party connected firms during the economic crisis (Gul, 2006; Gomez, 2003; Johnson and Mitton, 2003).

In addition, the lack of internal strengths and their inherent inefficiency reduce the likelihood of the ruling party connected firms securing various business opportunities available in the economic environment in the situation when their

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<sup>17</sup> A firm's strengths include their efficiency and productivity, innovation and design of appropriate business strategies, including marketing strategies.

patrons are not in the position to influence the decisions as to the allocation of business opportunities. The lack of internal strengths and their inherent inefficiency also imply that, even with assistance from government and/or politicians, these firms may still be at risk of not being able to achieve their business objectives (Faccio et al. 2006; Gomez, 2005; Gomez and Jomo, 1997). For example, Faccio et al. (2006) find that bailed-out firms that are ruling party connected demonstrate worse financial performance than non-politically connected firms during the time of the bail-out and two years following the bail-out. Moreover, their reliance on political patronage implies that the firms' fortunes are closely dependent on whether the politicians and the government that they are politically connected with remain in power (Gomez, 2005). Prior research provides evidence that ruling party connected firms are negatively affected when their patrons are no longer in power (Goldman et al., 2008; Goldman, et al., 2009; Knight, 2007; Shon, 2010; Jayachandran, 2006; Johnson and Mitton, 2003). The risk associated with their reliance on political connections for growth and expansion as well as survival could offset the benefits and favours received through political connections. This, in turn, increases their overall business risk.

In view of the potential favours and benefits to be obtained from political connections, firms are willing to spend a considerable amount of resources in various rent seeking activities in order to establish and/or maintain the political connections with the political leaders or the government that are in power. In some countries, such as the US, political donations and lobbying expenses are regulated where they must be disclosed in the financial statements. However, in Malaysia, political donations are not regulated and no specific disclosure is required. Given that the resources spent for the purpose of rent seeking activities can take various forms such as political donations,



gifts, lobbying expenses and events sponsorship, the total amount allocated for the rent seeking activities are not always explicitly disclosed in the financial statements.

The nature of the rent seeking activities implies that it is almost impossible for a firm's shareholders to figure out and scrutinise the total amount spent for rent seeking activities. Hence, in the short-term, the amount of resources allocated to rent seeking activities could far exceed the benefits obtained from the political connections, particularly when management anticipates that the firm would reap the benefits and favours from the political connections over the longer term. The allocation of resources for rent seeking activities could divert a firm's scarce resources away from the firm's core business activities. This, in turn, could lead to higher business risk for ruling party connected firms.

Prior research also provides evidence that ruling party connected firms tend to pursue political goals ahead of firm value maximisation (Boubakri et al. 2008; Fan et al., 2007; Bertrand et al., 2007). For example, in the Malaysian context, Gomez (2005, p. 38) asserts that "since Mr Anwar's allies were politicians who had ventures in business principally to fund their political activities, their style of business was less productive, with many of them showing little capacity to build on their concessions". The focus of ruling party connected firms on political goals instead of value maximisation for shareholders could increase their business risk.

Findings in prior research also indicate that ruling party connected firms are less transparent in their financial reporting. Leuz and Oberholzer-Gee (2006) provide evidence that ruling party connected firms in Indonesia prefer to raise capital from the domestic financial market, which requires less transparency rather than foreign financial markets, which require more transparency. The authors assert that the

requirement for higher transparency in foreign markets makes it harder for ruling party connected firms to continue their rent seeking activities, especially when the activities are dubious in nature (Leuz and Oberholzer-Gee, 2006). Furthermore, the quality of earnings reported by ruling party connected firms are poorer in comparison to similar non-connected firms (Chaney et al., 2011 and Correia, 2010). According to Chaney et al. (2011, p. 59) “to the extent that politicians provide protection to their related companies so that low quality accounting information is not penalized, connected firms might simply care less about the quality of the information they disclose, and invest less time to accurately portray their accruals”. The lack of transparency for politically connected firms increases earnings opacity, hence leading to earnings forecast error (Chen et al., 2010; How et al., 2009). Chen et al. (2010) argue that the distortion cause by political favouritism makes it difficult for analysts to forecast the earnings of ruling party connected firms.

The lack of transparency in financial reporting for ruling party connected firms, especially with regard to the recording of rent seeking activities could also lead to an adverse reaction by market participants, particularly shareholders, if they find out about the activities and the amount of resources that have been allocated to those activities (Smith, Stettler and Beedles, 1984). Politically connected firms could also incur direct costs of shareholders’ litigation, especially in the scenario where there is an excessive amount of resources allocated to the rent seeking activities without a corresponding increase in firm value (Lyon and Maher, 2005). This is especially relevant when in reciprocating the favours and benefits provide by their patrons. Politically connected firms choose to act in the interests of the patrons although it may be in conflict with the best interests of shareholders. Hence, the less transparent

nature of the disclosure of resources allocated to rent seeking activities is a factor that could lead to a higher business risk for ruling party connected firms.

Overall, the discussion above demonstrates that, although auditors in the ruling party connections group will identify political connections as a factor that decreases a client business risk, it does not necessarily lead to a lower overall assessment of business risk for a client with ruling party connections compared to a client with no political connections. The various costs and drawbacks associated with ruling party connections may offset the benefits and favours that can be accessed through such connections, hence leading to a high overall assessment of business risk for a client with ruling party connections. Even though non-politically connected firms do not have preferential access to various benefits and favours provided by politicians or the government in power, these firms are not subject to the costs and drawbacks associated with ruling party connected firms. Based on the arguments, the following hypothesis is proposed:

H2a: The average assessment of a client's business risk is higher for a client with ruling party connections than for a client with no political connections.

For firms with opposition party connections, in addition to the fact that they are not likely to receive favours and benefits and are prone to negative treatment by politicians or the government currently in power, these firms are also associated with some of the costs and drawbacks linked to the ruling party connected firms above. Similar to ruling party connected firms, opposition party connected firms spend their resources on rent seeking activities in order to establish and/or maintain political

connections with the opposition leaders or the opposition party. However, the involvement of opposition party connected firms in rent seeking activities is dependent on the likelihood of the opposition leaders or opposition party winning the country's election.

This is due to the fact that opposition party connected firm will only reap the benefits from their political connections when the opposition party or the opposition leaders win the country's election and become the ruling government. For example, in Malaysia, Barisan Nasional has won all the country's general elections (at the federal level) since Malaysia obtained its independence in 1957. The best performance of the opposition party (Pakatan Rakyat) was in the 12<sup>th</sup> general elections in March 2008, where, for the first time in the country's history, the opposition managed to deny Barisan Nasional's a two thirds majority in federal parliament. Given that historically the opposition party has never won a general election (at the federal level), the involvement of opposition party connected firms in rent seeking activities is lower than firms with ruling party connections. For opposition party connected firms, until the opposition wins an election and becomes the ruling party, the amount of resources allocated to rent seeking activities could far exceed the benefits obtained from the political connections. This has a negative effect on business risk for opposition party connected firms.

The less transparent nature of the disclosure of resources allocated to rent seeking activities combined with the fact that the rent seeking activities do not create value for shareholders until the firms' patrons are in power, exposes opposition party connected firms to potential litigation by their shareholders. Similar to ruling party connected firms, opposition party connected firms would avoid explicitly disclosing the

rent seeking activities that are dubious in nature. Unlike ruling party connected firms, opposition party connected firms are not in a position to be protected by the politicians for the lack of accounting disclosure. This, in turn, increases the risk of an enforcement action by the regulators.

In all, negative treatment and potential retaliation from the politicians or government in power, combined with various other costs and drawbacks associated with opposition party connections leads to a high overall business risk assessment for a client with opposition party connections. In contrast to opposition party connected firms, firms with no political connections are not subject to negative treatment and retaliations from politicians or the government currently in power. The costs and drawbacks associated with opposition party connected firms are irrelevant to non-politically connected firms. Hence, the existence of opposition party connections could lead to a higher business risk assessment compared to the absence of any political connections. Based on this argument, the following hypothesis is proposed:

H2b: The average assessment of a client's business risk is higher for a client with opposition party connections than for a client with no political connections.

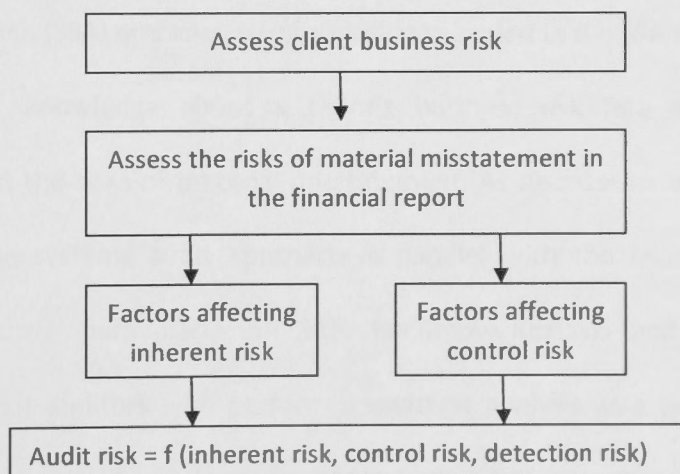
Given that ruling party connected firms and opposition party connected firms are associated with high business risk, it is expected that there will be no difference in the auditors' average assessments of business risk for a client with ruling party connections and for a client with opposition party connections. This argument suggests the following hypothesis:

H2c: There is no difference in the average assessment of business risk for clients with ruling party connections and opposition party connections.

### 3.3 Risks of Material Misstatement, Audit Effort and Audit Fee

Prior research provides evidence that the understanding auditors acquire when they analyse the client's business and its environment affects their subsequent audit judgements (O'Donnell and Schultz, 2003; Bierstaker and Wright, 2004; Kopp and O'Donnell, 2005; O'Donnell and Schultz, 2005; Schultz, Bierstaker and O'Donnell, 2010; Kochetova-Kozloski and Messier, 2010; Knechel, Salterio and Kochetova-Kozloski, 2010; Kochetova-Kozloski, Kozloski and Messier, 2010). Gay and Simnett (2010) discuss the relationship of client business risk assessment and the risks of material misstatements assessment to the determination of audit risk (Refer to Exhibit 3.2).

**Exhibit 3.2: The relationship of client business risk and the risks of material misstatement in the financial statements and the determination of audit risk (Gay and Simnett, 2010, p. 213)**





Based on a holistic picture of a client's business and its environment developed during the assessment of business risk stage, auditors then assess the client's risks of material misstatement in the financial statements. ISA 315.A31 suggests that "an understanding of the business risks facing the entity increases the likelihood of identifying the risks of material misstatement, since most business risks will eventually have financial statement consequences and, therefore, an effect on the financial statements". Auditors are required to assess the risks of material misstatement at the financial statement level and the assertion level (for classes of transactions, account balances and disclosures) (ISA 315.25). The risks of material misstatement at the assertion level consist of two components; inherent risk and control risk (ISA 200.13 (n)). However, according to ISA 200.A40, the auditing standards "do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the risks of material misstatement".

The risks of material misstatement can be due to error or fraud (ISA 200.13 (b)(i)). Schultz et al. (2010) provide evidence that auditors who use the strategic systems approach (SSA) and analyse information provided in the SSA format effectively integrate their knowledge about a client's business risk into their subsequent judgment about the risks of material misstatement. As discussed earlier, the essence of the strategic systems audit approach is parallel with the requirements in the auditing standards, particularly ISA 315. Kochetova-Kozloski and Messier (2010) demonstrate that auditors who perform a strategic analysis as a way to acquire an understanding of a client and its environment make more accurate assessments of the risks of material misstatement compared to auditors who do not perform the strategic analysis. Kochetova-Kozloski et al. (2010) find that auditors who identify more entity

level business risks make higher assessments of the client's risks of material misstatement at the entity level. These studies demonstrate that auditors' assessments of business risk influence their subsequent assessment of the risks of material misstatement that can arise from fraud or error.

Fraud is "an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage" through fraudulent financial reporting or misappropriation of assets (ISA 315.11(a)).<sup>18</sup> Fraudulent financial reporting is an intentional misstatement of financial statements through omissions of amounts or disclosures to deceive users of the financial statements. Appendix 1 of ISA 240 describes a number of fraud risk factors that should be considered by auditors when assessing the client's fraud risk. These factors are categorised as incentives/pressures, opportunities and rationalisation. The incentives/pressures include the economic, industry or entity operating conditions that could threaten the financial stability or profitability of a firm.

Among the factors described as incentives/pressures by ISA 240 are: (1) high degree of competition or market saturation, accompanied by declining profit margins; (2) significant declines in customer demand and increasing business failures in the industry or the overall economy; (3) rapid growth or unusual profitability in comparison to other companies in the same industry; and (4) the need to obtain additional debt or equity financing to remain competitive. According to ISA 240,

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<sup>18</sup> Refer to Wells (2007) for a discussion about different kinds of fraud.

opportunities include: (i) the existence of significant related party transactions that are not in the ordinary course of business; (ii) the existence of significant, unusual, or highly complex transactions; and (iii) ineffective oversight by those charge with governance over the financial reporting process.

These factors should be considered by auditors when obtaining an understanding of the client's business and its environment and when assessing the client's business risk. Their assessment of a client's business risk, in turn, affects their subsequent judgement of the risks of material misstatement. This is in line with prior research that provides evidence that auditors incorporate their assessment of business risk into the subsequent assessment of the risks of material misstatement (Schultz et al., 2010; Kochetova-Kozloski and Messier, 2010; Kochetova-Kozloski et al., 2010).

Consider the scenario discussed earlier with regard to a firm in the construction industry. From one perspective, the various benefits and favours received by ruling party connected firms could reduce the firm's incentive to misstate their financial statements, hence leading to lower fraud risk. For example, Gul (2006, p. 938) argues that due to the assistance and favours received by ruling party connected firms from government during the Asian economic crisis, "it is likely that managers of these firms had less incentive to misstate financial statements". However, from another perspective, the costs and drawbacks associated with ruling party connections as discussed above could increase the risks of material misstatements due to fraud. The fact that ruling party connected firms rely on political connections for their growth, expansion and survival that contribute to their inherent efficiency could negatively affect the firm's performance during the time when innovation, productivity and efficiency are critical for the firm's success, such as during an economic crisis.

Although the firms are in a position to receive various favours and benefits from the government during the crisis, these benefits and favours do not necessarily lead to better performance due to the firm's inherent inefficiency. This could increase fraud risk as management is under pressure to meet shareholders' expectations, particularly when a substantial amount of resources have been allocated to rent seeking activities. The fact that favours and benefits are received through various related party transactions (Gomez and Jomo, 1997; Chen et al., 2011) could provide opportunity for fraudulent financial reporting, hence increasing the fraud risk for firms with ruling party connections (ISA 240; ISA 550; Henry, Gordon, Reed and Louwers, 2007).<sup>19</sup> Furthermore, the complex nature of some rent seeking activities and the less transparent nature of their disclosure in the financial statements of politically connected firms (Leuz and Oberholzer-Gee, 2006) may increase the opportunity for management to commit financial statement fraud (ISA 240). This, in turn, leads to higher risks of material misstatement due to fraud for ruling party connected firm.

Unlike ruling party connected firms, the growth, expansion and survival of non-politically connected firms are based on the firm's own internal strengths. Consider the example discussed earlier with regard to a firm in the construction industry. During an economic crisis where private sector companies decide to put on hold many construction projects planned, non-politically connected firms can capitalise on their innovation, efficiency and productivity to generate as much value from existing

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<sup>19</sup> Henry et al. (2007) examine the relationship between frauds and related party transactions. They find that instances of fraudulent financial reporting are more often associated with related party transactions where the cash flow from the transactions is expected to be inward, such as a firm's borrowings from related parties.

projects that they are working on. In ensuring prudent spending during an economic crisis, government may decide to award construction contracts under its economic stimulus package to firms that are innovative, efficient and productive so that the projects can be handed over to the government on time with the least cost. In this scenario, given the characteristics of non-politically connected firms, they are in the front line to be awarded the construction contracts. Moreover, in contrast to ruling party connected firms that are under pressure to ensure that the resources spent on rent seeking activities generate value to the shareholders, non-politically connected firms are not under such pressure. Unlike ruling party connected firms that receive favours and benefits through various means including through related party transactions, the fact that non-politically connected firms are not in a position to receive favours and benefits through political connections implies that there will be no related party transactions associated with political connections for the non-politically connected firms. The non-politically connected firm are also not associated with the lack of disclosure related to rent seeking activities. All of these reduce fraud risk for non-politically connected firms. The reasoning above leads to the following hypothesis:

H3a: The average assessment of a client's fraud risk is higher for a client with ruling party connections than for a client with no political connections.

The fact that opposition party connected firms are not in a position to receive favours and benefits from politicians or government that are in power and prone to negative treatment from them could lead to higher fraud risk for these firms. Recall the earlier example about a firm in the construction industry. During an economic

crisis where government interference through various economic stimulus programs is crucial, opposition party connected firms are not in a position to benefit from such programs. Given that private sector companies decide to put on hold many construction projects, opposition party connected firms are left only with their existing projects. This could increase fraud risk as management is under pressure to meet shareholders' expectations, particularly when a substantial amount of resources allocated to rent seeking activities are not generating value for shareholders. On top of that, the complex nature of some rent seeking activities and the less transparent nature of their disclosure in the financial statements of politically connected firms (Leuz and Oberholzer-Gee, 2006) may increase the opportunity for management to commit financial statement fraud (ISA 240). This, in turn, leads to higher risks of material misstatement due to fraud for firms with opposition party connections. This argument leads to the following hypothesis:

H3b: The average assessment of a client's fraud risk is higher for a client with opposition party connections than for a client with no political connections.

Given that ruling party connected firms and opposition party connected firms are associated with higher fraud risk, it is expected that there will be no difference in the auditors' average assessment of fraud risk for a client with ruling party connections and those with opposition party connections. This argument suggests the following hypothesis:



H3c: There is no difference in the average assessments of fraud risk for clients with ruling party connections and those with opposition party connections.

Unlike fraud, errors are unintentional misstatements in the financial statement due to things such as omissions, incorrect calculations, mistakes in data entry, incorrect disclosures, incorrect classifications, application of incorrect accounting policies, etc. According to ISA 315.12, auditors are required to obtain an understanding of the client's internal control relevant to the audit. An understanding of the client's internal control environment allows auditors to assess, among others, the risks of material misstatement due to error. Although the risks of material misstatement due to error are closely related to the design and the strength of a client's internal control environment, the nature of the client's operations also plays a crucial role. For example, the risk of error is higher for a firm that is involved in complex transactions compared to a firm that is not involved in such transactions although both clients have the same design and strength of internal control environment.

Since there is no requirement for firms in Malaysia to explicitly disclose political contributions in their financial statements, the resources they spend for rent seeking activities are recorded and disclosed at management's discretion. The complex nature of some rent seeking activities, especially those that are dubious in nature may lead to incorrect recording or incorrect classifications of the transactions. This increases the risk of error in the financial statements of ruling party connected firms.

In addition, the fact that ruling party connected firms receive benefits and favours from their political connections through various means, including through related party transactions (Gomez and Jomo, 1997; Chen et al., 2011), increases the

risk that some of the related party transactions are not disclosed or disclosed incorrectly. In all, the nature of rent seeking activities and the benefits and favours received by ruling party connected firms increase the risk of error in their financial statements. In contrast, non-politically connected firms are not involved in rent seeking activities and do not receive favours and benefits through political connections. Hence, it is expected that the average error risk assessments for a client with ruling party connections will be higher than for a client with no political connections. This reasoning leads to the following hypothesis:

H4a: The average assessment of a client's error risk is higher for a client with ruling party connections than for a client with no political connections.

As opposition party connected firms are also involved in rent seeking activities (although to a lesser extent compared to ruling party connected firms), it is expected that auditors' average error risk assessment for a client with opposition party connections will be higher than for a client with no political connections. This leads to the following hypothesis:

H4b: The average assessment of a client's error risk is higher for a client with opposition party connections than for a client with no political connections.

As opposition party connected firms only reap benefits and favours from their political connections once the opposition leaders or opposition party that they support win an election and become the ruling government, the firms' involvement in rent

seeking activities are at a lesser extent compared to ruling party connected firms. This, in turn, lowers the potential risk of error associated with recording and disclosing rent seeking activities compared to firms with ruling party connections. In addition, the fact that opposition party connected firms do not receive benefits and favours from their political connections reduces the likelihood of error related to disclosure of related party transactions. Based on this reasoning, it is expected that auditors' average assessment of error risk will be higher for a ruling party connected client compared to an opposition party connected client. The reasoning leads to the following hypothesis:

H4c: The average assessment of a client's error risk is higher for a client with ruling party connections than for a client with opposition party connections.

Auditors' average assessments of the risks of material misstatement affect their subsequent judgement of audit risk. According to ISA 200.A42, the greater the risks of material misstatement that auditors believe exist in the client's financial statements, the more audit evidence required by the auditors in order to reduce audit risk to an acceptable level. Higher risks of material misstatement imply that auditors need to increase their audit effort in order to gather the required evidence and provide an appropriate audit opinion.<sup>20</sup> This will result in a higher audit fee being charged to the client (Charles, Glover and Sharp, 2010; Bedard and Johnstone, 2004; Gul, Chen and Tsui, 2003; Beaulieu, 2001). Gul (2006) argues that the higher risks of material

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<sup>20</sup> Although the risks of material misstatement also affect the nature and the timing of audit procedures, it is beyond the scope of this thesis.

misstatement associated with ruling party connected firms at the onset of the Asian financial crisis lead to a greater increase in audit fees for ruling party connected firms compared to non-politically connected firms. Given that the risks of material misstatement for ruling party connected firms are higher than non-politically connected firms, the following hypotheses are suggested:

H5a: The average assessment of required audit effort is higher for a client with ruling party connections than for a client with no political connections.

H6a: The average recommended audit fee for a client with ruling party connections is higher than for a client with no political connections.

As the risks of material misstatement for opposition party connected firms are higher than non-politically connected firms, the following hypotheses are suggested:

H5b: The average assessment of required audit effort is higher for a client with opposition party connections than for a client with no political connections.

H6b: The average recommended audit fee for a client with opposition party connections is higher than for a client with no political connections.

Although ruling party connected and opposition party connected firms are associated with higher fraud risk, the fact that opposition party connected firms have a lower risk of error implies that the overall risks of material misstatement for

opposition party connected clients is lower than for ruling party connected clients. The reasoning leads to the following hypotheses:

H5c: The average assessment of required audit effort is higher for a client with ruling party connections than for a client with opposition party connections.

H6c: The average audit fee recommended for a client with ruling party connections is higher than for a client with opposition party connections.

### **3.4 Summary**

This chapter discusses the development of the hypotheses to be tested in this thesis. The first part of the chapter outlines the relationship between the understanding of a client and its environment auditors acquire and their assessment of the client's business risk. This is then followed by the relevant hypotheses. The second part of the chapter discusses the relationship of business risk assessment and risks of material misstatement to the determination of audit risk, which, in turn, influence the assessment of the required audit effort and the recommended audit fee. It is then followed by hypotheses related to the assessment of fraud risk and error risk as well as the hypotheses related to audit effort and audit fee. The research method used in this study is discussed in the next chapter.

## **CHAPTER 4**

### **Research Method**

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#### **4.1 Introduction**

This chapter first explains the experimental research method used. The objective of the experiment is to investigate the effects of political connections on auditors' risks assessments and judgements about the required audit effort for the engagement and recommended audit fee. Section 4.3 of the chapter explains the development of the case materials used in the research. This is followed by Section 4.4, which explains the administration of the experiment, including the tasks performed by participants and the dependent variables. Section 4.5 describes the manipulation checks. Section 4.6 discusses the scales used to measure auditors' perceptions of business dealings and political connections in Malaysia. In Section 4.7, the instrument used to measure auditors' professional scepticism is explained. Section 4.8 discusses the recruitment of participants and the incentive offered to participate in the experiment. In Section 4.9, the ethics approval obtained for this research is explained. Section 4.10 summarises the chapter.

#### **4.2 Research Method and Design**

The literature reviewed in Chapter 2 demonstrates that the existence of political connections is beneficial to ruling party connected firms and the loss of such connections or the existence of opposition party connections is detrimental. In the current research, the effects of political connections on the assessments of risks, audit effort and audit fees are examined using an experimental research method. Maines,



Salamon and Sprinkle (2006, p.99) assert that “the primary strength of experiments, compared to other empirical approaches, is the ability to infer the direction of causality between independent and dependent variables”. Peecher and Solomon (2001, p.195) consider experiments as “one of the most powerful” methods to “test and refine theories about causal relationships”. In experimental research, the researcher manipulates one or more independent variables and holds all other variables constant or measured (Trotman, 2001; Libby, Bloomfield and Nelson, 2002). The manipulation involves providing treatment groups with case materials of different manipulated contents. In audit judgement research, the development of case materials is critical. Choosing the appropriate setting and context for the case material is one of the most important decisions that researcher need to consider (Gibbins, 2001; Gibbins and Swieringa, 1995).

The absence of prior research utilising an experimental method to investigate the effects of political connections may be attributable to the complexities in choosing the appropriate setting and context, and the difficulties in manipulating political connections. Kerlinger and Lee (2000) suggest that experimental researchers need to be creative when manipulating independent variables that initially appear to be impossible to manipulate.

In this study, the independent variable, political connections, is manipulated on a between-subjects basis at three levels: (1) ruling party connections; (2) opposition party connections; and (3) no political connections. The next section discuss in detail the setting and context of the case materials and the manipulation of political connections.

### 4.3 Development of Case Materials

In the absence of prior research that manipulates political connections as an independent variable to be used as a guide, the decision on the appropriate setting and context for the case materials was carefully considered. Among other factors, this involved deciding: (1) the industry that the hypothetical firm in the case materials is operating in; (2) the economic conditions and competitive environment in the industry; and (3) the financial year under audit. These form the basis for the development of case materials that are appropriate in relation to the manipulation of the independent variable. In developing the industry setting for the case materials, various literatures, annual reports, news reports and economic and industry reports were reviewed.

Gomez and Jomo (1997) name some of the industries in Malaysia where the existence of political connections is crucial. These industries are: construction; real estate; supplies; transport; logging; finance; and mining. They suggest that firms with ruling party connections in these industries are more likely to be successful compared to their opposition party connected or unconnected competitors. Among all the industries listed by Gomez and Jomo (1997), anecdotal evidence and prior literature suggest that political connections are prevalent in the construction industry (Anassi, 2004; MacIntyre, 2003; Gomez, 2003; Gomez and Jomo, 1997). Therefore, the hypothetical firm used in the case materials operates in the construction industry.

In finding an appropriate setting for the manipulation of political connections in the construction industry, prior literature that examines the benefits of political connections was reviewed. According to the literature, ruling party connections allow firms to: (1) have easier access to financing facilities (Faccio, 2010; Jiang, 2009;

Claessens et al., 2008; Charumilind et al., 2006; Khwaja and Mian, 2005) at a lower financing cost (Boubakri et al., 2010); (2) receive preferential treatment from the government in securing government procurement contracts (Goldman et al., 2008); and (3) obtain relevant licences and the necessary approvals (Du and Girma, 2010; Li et al., 2008; Agrawal and Knoeber, 2001). Therefore, the case materials include information related to financing facilities, government contracts and the requirement to obtain the necessary approvals from government. The case materials have been designed in such a way if the existence of political connections is beneficial to a firm, then a firm that is politically connected to the government in power is more likely to achieve its objectives compared to unconnected firms or firms connected to the opposition party. This is discussed in detail in the next three subsections.

Prior research provides evidence that assistance received from government during the economic crisis helps ruling party connected firms to perform better than unconnected or opposition party connected firms (Johnson and Mitton, 2003; Gul, 2006). According to Johnson and Mitton (2003), the introduction of capital controls by the Malaysian government<sup>21</sup> during the Asian economic crisis accounts for roughly 32% of the gain in the market value of ruling party connected firms. They assert that the support received by ruling party connected firms, through the introduction of capital controls, contributed to the gain. Consistent with Johnson and Mitton (2003), Gul (2006) provides evidence that the introduction of capital controls leads to a decline in audit fees for ruling party connected firms. He argues that the capital controls assisted

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<sup>21</sup> Johnson and Mitton (2003) argue that the capital controls were introduced to assist politically connected firms.

the politically connected firms financially. This, in turn, reduced the risks of material misstatement. In the current research, the period during the global financial crisis that began in the United States in early 2008 is used to provide a similar scenario to the Asian economic crisis, which is the scenario examined by Johnson and Mitton (2003) and Gul (2006).

The year 2009, where the global financial crisis is at its peak, is chosen as the year under audit as it provides an appropriate scenario to examine the effects of political connections on businesses. The 2009 financial year was a very challenging time for businesses all over the world due to the global financial crisis. In such an environment, every firm in the same industry faces similar external pressures and challenges. The introduction of any new policies and initiatives by the government in battling the crisis, such as an economic stimulus program, should have a similar impact on every firm in the industry. However, if political connections are beneficial to ruling party connected companies, then the introduction of new policies or initiatives are more likely to have a positive impact on companies that are connected to the government in power compared to unconnected companies or companies connected to the opposition party.

Before the case materials were finalised, they were reviewed by six accounting academics, two practitioners and a former Senior Manager at Bursa Malaysia. Their feedback allowed the researcher to assess the appropriateness of the case materials and the appropriateness of the tasks contained in the research instrument. Based on the feedback received, a number of changes were made to the initial case materials and tasks.

### 4.3.1 Background Information

This section of the case materials provides general information about the firm. This includes information about: (1) business management and objectives; (2) target market; (3) accounting and control environment; and (4) a debt covenant. The background information is based on a number of real construction companies listed on Bursa Malaysia, construction industry reports, news reports and prior research in corporate governance, auditing and political economy.

In the background information, the firm is described as “a relatively small construction firm that conducts its business throughout the country”. The rationale for choosing a small firm is to avoid potential confounding effects of overseas operations as it brings a different set of risks and opportunities to the firms, which, in turn, could affect the firms’ overall performance. For example, in the situation where the domestic construction industry is declining, firms with overseas operations are able to cushion the decline in revenue from its domestic operations by generating revenue from its overseas operations. Or, if the domestic market is very competitive with small profit margins, firms that have operations in countries where the market is largely untapped and less competitive could perform better than firms that operate only in the domestic market. In order to investigate the effects of political connections on auditors’ judgements of the firm’s risks and performance, it is important that the firm in the case materials generates all of its revenue in the country where it has the political connections. This is to ensure that their judgments are not being influenced by the existence of overseas operations.

From an analysis of construction firms in Malaysia, most big and medium size construction firms have overseas operations. Therefore, it is not realistic for big or

medium size firms in Malaysia to not have overseas operations. Therefore, to make the case materials more realistic, the firm in the case is described as a small firm. To make the fact that the firm does not have overseas operations more salient, it is explicitly mentioned in the case materials that the firm “has no overseas operations”. The background information indicates that the firm focuses its business in a number of states, namely Johor, Negeri Sembilan, Melaka, Perak, Sabah, Sarawak and Federal Territory Kuala Lumpur. All of these states and the Federal Territory are controlled by the Barisan Nasional, which is also the ruling party at the federal level.

The background material also contains information about the board of directors’ political connections. This information is manipulated to indicate the board is either ruling party connected, opposition party connected or not connected to political leaders who are currently in power. Auditors in the ruling party connections treatment group are provided with information indicating that five out of seven board of directors, including the CEO, have a very close relationship with the country’s top political leaders at the federal level who are currently in power. In the opposition party connections treatment, the case materials include information that five out of seven board members, including the CEO, have a very close relationship with the country’s top opposition leaders at the federal level. In the no connections manipulation, the statement about the client’s political connections is omitted from the materials provided to participants. Except for information about the board of directors’ political connections, the other background information in the case materials is held constant. The manipulated information is shown in Exhibit 4.1(also in Appendix 2).



## **Exhibit 4.1: Manipulation of the Independent Variable (Political Connections)**

### **Ruling Party Connections**

Five out of seven board members have a very close relationship with the country's top political leaders at the federal level who are currently in power. They developed the relationship through an active involvement and close association with a political party that is currently the main party in the federal coalition government. For example, the Chairman of the Board, Khairul Hisham, is a former Member of Parliament representing the party for two terms. Two other board members are division leaders of the party in two of the divisions in Pahang. Another member is a division leader in a division in Johor.

The CEO, Ramlee, is also a very close friend of the country's top political leaders. They have known each other since their university days. For the past 25 years, Ramlee has been a staunch supporter of these leaders.

### **Opposition Party Connections**

Five out of seven board members have a very close relationship with the country's top opposition leaders. They developed the relationship through an active involvement and close association with a political party that is currently the federal opposition. For example, the Chairman of the Board, Khairul Hisham, is a former Member of Parliament representing the opposition party for two terms. Two other board members are division leaders of the opposition party in two of the divisions in Pahang and another member is a division leader in a division in Johor.

The CEO, Ramlee, is also a very close friend of the country's top opposition leaders. They have known each other since their university days. For the past 25 years, Ramlee has been a staunch supporter of these leaders.

The setting, context and time period chosen for the case materials could potentially affect the auditors' assessments of the risks of material misstatement. Hence, every effort has been taken to ensure that the other information in the case

materials reflect a firm with average risks of material misstatement. For example, it is mentioned that “the previous year’s audit work papers indicated that BCC (Bright Construction Company) has a good internal control system whereby the strength of internal control environment was assessed as moderate”.

#### **4.3.2 Industry Information**

Industry information provided in the case materials describes the firm’s external environment. This includes information about: (1) competition; (2) certificate of fitness; (3) financing facilities; and (4) the government stimulus plan. The case materials state that construction is a very competitive industry where in the “past few years, the price of materials such as steel, sand and cement have been rising and this has eroded profit margins, sometimes to single-digit levels”. It is also mentioned in the case materials that “many small and medium size companies are struggling to generate sufficient revenue to remain in operation”. Under such a competitive environment, there is considerable pressure on every firm to control and manage scarce resources in the external environment that are crucial to the achievement of their business objectives. According to resource dependence theory, one way to control such resources is through the appointment of a board of directors who can bring the necessary experience, knowledge and resources to the firm. This includes a board of directors who is connected to the country’s leaders currently in power, which is the manipulated independent variable.

The case materials also contain information about the need for construction firms to obtain a certificate of fitness from the relevant authority for any completed project before the project can be handed over to the project owner. This item is based

on prior research, which argues that politically connected firms use their connections to obtain favour from the government, including obtaining necessary approvals (Li et al., 2008; Agrawal and Knoeber, 2001).

The availability of financing is described in the case materials as very limited. Private banks have tightened their credit policies and many construction companies rely on government-owned banks or banks that are closely linked to government for finance. The information also indicates that these banks receive strong backing from the government to provide financing to selected companies in order to support their operations, avoid potential bankruptcy, which, in turn, stimulates the economy. This setting provides a context in which the existence of political connections can be beneficial to firms connected to the government in power through easier access to finance (Claessens et al., 2008; Charumilind et al., 2006; Khwaja and Mian, 2005; Li et al., 2008).

The case materials also state that, in order to stimulate the domestic economy and to ease the impact of the global financial crisis on Malaysia, the government introduced a number of economic stimulus initiatives at the end of 2008. The case materials indicate that the government has allocated approximately RM20 billion to fund the construction of various public infrastructure and facilities. The government has decided that decisions on tenders for government projects in this stimulus package are not dependent solely on the price offered by the construction firms. Instead, decisions are at the government's discretion, which takes into consideration various other factors apart from the price tendered. This scenario provides a setting where politically connected firms can benefit from their political connections through

preferential treatment by the government in awarding the construction contracts available through the stimulus package (Goldman et al., 2008).

#### **4.3.3 Financial Statements**

The income statements provided to the participants are based on an analysis of the 2008 financial statements of all 47 construction firms listed on Bursa Malaysia. Based on the analysis, the largest revenue reported by these firms is RM6.5 billion and the lowest revenue is RM34 million. As discussed above, the firm in the case study is described as a small size firm in order to avoid confounding effects and to ensure that the manipulations are more salient. Therefore, the revenue of the firm is set as follows: 2009 = RM51 million; 2008 = RM37 million; and 2007 = RM47million.

The patterns of revenue and expenses are in line with patterns in the construction industry around that time. The year 2008 marked a significant decline in the construction industry. Hence, the revenue for the firm decreases from RM47 million in 2007 to RM37 million in 2008. In line with this, cost of sales and selling and administrative expenses also decrease. Interest expense remains approximately the same for 2007 and 2008 as the firm still needs to pay interest on the loans made regardless of the firm's performance. In 2009, the construction industry has still not recovered from the effects of the global financial crisis. Nevertheless, in an environment where construction firms are negatively affected by the global financial crisis, the firm reported higher revenue (unaudited revenue for 2009 is RM51.5 million compared to audited revenue of RM37.1 million for 2008). Consistent with the increase in revenue, cost of sales selling and administrative expenses also increase. In 2009, cost of sales as a percentage of revenue, and selling and administrative expenses

as a percentage of revenue increase by 8.7% and 0.4% respectively. The larger increase in cost of sales as a percentage of revenue compared to the increase in selling and administrative expenses as a percentage of revenue can be attributable to increases in the price of materials used in construction such as steel, sand and cement. The interest expense also increases in 2009. The higher interest expense for 2009 than for 2008 is due to higher borrowings by the firm in order to fund its business in 2009 (Refer to Appendix 2).

For 2009, the firm's gross profit ratio is lower than in 2008 (35% in 2009 compared to 43% in 2008). This can be explained by: (1) the higher cost of sales in 2009 as a result of an increase in the price of materials; and (2) stiff competition in the market where all firms are tendering their lowest possible quotation in order to win construction contracts. However, the firm's gross profit ratio for 2009 is higher than the industry average (35% for the firm compared to 31% for the industry average). The higher than expected unaudited revenue and gross profit ratio are unexpected given the trend in the construction industry in general. However, these could be explained by several reasons. First, the firm might have received a portion of the RM20 billion stimulus package allocated by the government for the construction of various public infrastructure and facilities. The likelihood of obtaining some of these construction contracts is higher for ruling party connected firms than for unconnected or opposition party connected firms. Second, management may have overstated revenue by manipulating the percentage of completion and/or the estimated costs to complete the contracts (Wells, 2007, p. 367). Third, it could be due to errors in recognising revenue using the percentage of completion method.

#### **4.4 Administration of the Experiment and Tasks Performed by Participants**

The recruitment of auditors as participants for this research is explained in detail in Section 4.8. Once potential participants were identified, they were approached either by the researcher or by the contact person in the participating firms. The participants were provided with all the required materials. The experiment was not conducted under a controlled setting. Instead, participants completed the instrument at their own convenience.

Each participant received an envelope that contained an information sheet, a consent form, a research instrument and a voucher payment form (Refer to Appendix 1 and Appendix 2). The information sheet contained information about: (1) the research objectives; (2) the voluntary nature of participation in the research; (3) the incentive payment to participants; (4) an assurance of confidentiality; and (5) the contact details of the researcher and the Human Research Ethics Committee. Participants were required to sign the consent form as an agreement to take part in the research. A voucher payment form is used to facilitate the payment of an incentive to the participants.

After completing the consent form, participants read the introduction to the instrument, which explained the research including a brief description of the task to be performed, a statement of ethical conduct and the researcher's contact details (the full version of the instrument used in this research is shown in Appendix 2). Next, the participants read Part 1 of Section 1 of the case materials, which contained the background information about the firm and information about the construction industry. The case materials centred on a hypothetical construction client, Bright Construction Company (BCC). Participants were told to assume that they are an audit



manager assigned to the audit of BCC for the year ended December 31, 2009. The audit firm has been the independent auditor of BCC for the past 3 years. Participants were informed that it is the first time they have been assigned to the audit of BCC.

At the end of Part 1 of Section 1, the participants performed two tasks. The responses to these two tasks are used to measure the first dependent variable, i.e., the assessment of client business risk. In the first task, participants assessed the client's business risk using a 7-point Likert scale with the endpoints being 7 = Very High Risk and 1 = Very Low Risk with 4 = Average Risk as the midpoint. In the second task, participants were asked to list all the factors that they believe increase the client's business risk as well as factors they believe decrease the client's business risk. The purpose of this task is to see whether the participants list political connections as a factor that increases and/or decreases the client's business risk.

Next, in Part 2 of Section 1, they were provided with the 2009 unaudited income statement together with the 2008 and 2007 audited income statements. They were also provided with the result of analytical procedures in the form of ratios based on the income statements. These ratios are: gross profit ratio; cost of sales as a percentage of revenue; selling and administrative expenses as a percentage of revenue; interest expense as a percentage of revenue; and the interest coverage ratio. Participants were also provided with graphical representations of the ratios for 2009, 2008 and 2007. Revenue and cost of sales decrease in 2008 but increase again 2009. Although revenue is higher in 2009, the gross profit ratio is lower in 2009 compared to 2008 and 2007. Cost of sales as a percentage of revenue, selling and administrative expenses as a percentage of revenue and interest expense as a percentage of revenue indicate a positive trend. The interest coverage ratio, on the other hand, has a negative

trend. For a more detailed discussion about the patterns in the income statements and ratios, refer to Section 4.3.3.

The participants were informed that the fluctuation in the gross profit ratio is considered to be unexpected and material. Participants were then required to indicate their separate assessments of fraud risk and error risk on a 7-point Likert scale ranging from 7 = Very High Risk to 1 = Very Low Risk with 4 = Average Risk as the midpoint. These are used to measure the second dependent variable (fraud risk assessment) and the third dependent variable (error risk assessment). Participants were asked to assess the client's fraud risk and error risk on 7-point Likert scales ranging from 7 = Very High Risk to 1 = Very Low Risk with 4 = Average Risk as the midpoint.

After making these assessments, the participants were provided with three potential reasons to explain the unexpected fluctuation in the gross profit ratio. The three reasons are: (1) unintentional errors either made by users of the accounting system or other accounting system error during 2009; (2) fraudulent financial reporting; and (3) non-error explanations. They were required to indicate the probability that each of the three reasons explain the higher than expected gross profit ratio by allocating a total of 100 points to the three potential reasons. The 100 points allocation represents the probability that each of the three reasons explain the higher than expected gross profit ratio. Participants could assign probabilities of 0% to 100% to each of the potential reasons as long as the total of all probabilities is equal to 100%. The probabilities are used as measures for their assessments of fraud risk and error risk.

Next, in Part 3 of Section 1, the auditors were required to make a number of assessments that are used to measure the fourth and fifth dependent variables, i.e.,

the amount of audit effort they would allocate to the audit of the client and the audit fee they recommend the client be charged. The fourth dependent variable, audit effort, is measured three ways. First, participants were required to indicate the amount of audit effort that they would allocate for the audit of the client compared to another client in the same industry with an average risk of material misstatement and that is of similar size. Participants indicated their response on a 7-point Likert scale ranging from 7 = Much higher effort to 1 = Much lower effort with 4 = Similar effort as the midpoint. Second, participants were required to indicate how many audit hours they would allocate to the audit of the client compared to another client in the same industry with an average risk of material misstatement and that is of similar size. Participants indicated their response on a 7-point Likert scale ranging from 7 = Much more hours to 1 = Much fewer hours with 4 = Similar number of hours as the midpoint. Third, participants were required to indicate the mix of audit personnel that they would allocate to the audit of the client compared to another client in the same industry with an average risk of material misstatement and that is of similar size. Participants indicated their response on a 7-point Likert scale ranging from 7 = Much higher proportion of senior auditor to 1 = Much lower proportion of senior auditor with 4 = Similar mix of audit personnel as the midpoint.

The fifth dependent variable is measured in two ways. First, participants were required to indicate how large an audit fee they would recommend that the client be charged for the audit, compared to another client in the same industry with an average risk of material misstatement and that is of similar size. Participants indicated their response on a 7-point Likert scale ranging from 7 = Much higher audit fee to 1 = Much lower audit fee with 4 = Similar audit fee as the midpoint. Second, participants were

provided with the current year's audit fee figures for two typical clients in the same industry that are comparable in size and complexity to the client under audit together with the assessed levels of risk of material misstatement in the financial statement. Based on the information provided, participants were required to indicate the audit fee they would charge the client.

Next, the participants were asked to indicate whether they think the case materials are realistic. They were also asked to answer two manipulation check questions (refer to Section 4.5). After completing the manipulation check questions, participants were required to indicate their agreement or disagreement with eight statements related to the relationship between political connections and businesses in Malaysia (refer to Section 4.6). Then in the last part of Section 1, participants were required to provide demographic information.

In Section 2, participants were required to answer 30 questions about themselves. The purpose of the questions is to see whether participant's professional scepticism affects their judgments about business risk, fraud risk, error risk, audit effort and audit fee. All questions in this Section are from the instrument developed by Hurtt (2010). This is discussed in detail in Section 4.7.

After completing the questionnaire, participants were required to place the completed questionnaire in the envelope provided, seal the envelope and return it to the researcher. Based on feedback received from a number of participants, on average, they took about 40-50 minutes to complete the research instrument.

#### 4.5 Manipulation Checks

Manipulation check questions were included in order to determine whether participants encoded and correctly interpreted the independent variable (Trotman, 2001; Libby et al., 2002). The questions required participants to indicate their agreement or disagreement with two statements. The first statement is “Ramlee Ahmad (the CEO) has a very close relationship to the country’s top political leaders who are currently in power”. The second statement is “The majority of BCC board members have a very close relationship to the country’s top political leaders who are currently in power”. Participants indicated their response on a 7-point Likert scale ranging from 7 = Strongly agree to 1 = Strongly disagree with 4 = Neither agree or disagree as the midpoint.

The responses from participants in the ruling party connections treatment are expected to be between 5 to 7 (inclusive) on the 7-point scale while responses from participants in the opposition party connections treatment are expected to be between 1 and 3 (inclusive). Although there is no information about the client’s political connections provided to the participants in the no connections group, the participants in this group were still required to provide answers to the manipulation check questions. This is to ensure that participants in all groups were provided with the same materials. This is especially important in the context of the research instrument as the questions following the manipulation check questions required participants to indicate their perceptions about business dealings and political connections in Malaysia. Not providing manipulation check questions to the participants in the no connections group could lead to systematic differences in their perceptions about business dealings and political connections in Malaysia compared to the other two

groups. The responses of participants in the no connections treatment to the manipulation check questions are expected to be in between 1 to 5 (inclusive). Since no information about political connections was provided to these participants, it is expected that the participants would disagree with the statements (1 to 4, inclusive) or they would neither agree nor disagree with the statements (3 to 5, inclusive).

If a participant did not provide the expected response to the manipulation check questions, the written answer they provided for the task that required them to list factors that increase and decrease business risk were examined (Section 1 (Part 1)). For example, if a participant in the ruling party connections treatment did not provide an expected response to the manipulation check questions but he/she identified that the existence of political connections decrease the client business risk because there is higher likelihood for the firm to obtain government construction contracts, then the participant is considered as having passed the manipulation check. Such a participant's response is not included as one that fails the manipulation check because their response shows that they noticed the cue and managed to encode and correctly interpret it (Libby et al., 2002; Trotman, 2001).

#### **4.6 Perceptions about Business Dealings and Political Connections**

Prior research provides evidence that auditors' perceptions of a client firm and its management can influence their judgements during an audit (e.g., Joe, 2003; McKinley, Ponemon and Schick, 1996; Salterio, 1996). Similarly, auditors' perceptions about: the importance of the relationships between firm and politicians and/or political organisation; and the inherent characteristics of politically connected firms,



can have an impact on their judgments during the audit of a politically connected client.

Participants were asked eight questions to assess their perceptions in relation to business dealings and political connections in Malaysia. These questions were developed based on the literature on political economy and auditing. Rajan and Zingales (1998) describe East Asian economies (which include Malaysia) as relationship-based systems. In these systems, the existence of a mutual close relationship between firms and various parties in the business environment is crucial to their success. Instead of being dictated by market forces or price signals provided by the market, business dealings and contract decisions in relationship-based systems are made based on the relationships and close ties between the parties involved. The contracts are also poorly enforced. Relationship-based systems are also characterised by a lack of transparency in business dealings and contracts.

Gomez and Jomo (1997) describe, in detail, the existence of close personal relationships between firms and politicians in Malaysia. They argue that politically connected firms in Malaysia receive various favours from the government, especially with respect to privatisation opportunities, licences, government contracts and funding (Gomez and Jomo, 1997, p.9). Politically connected firms, namely the state-owned enterprises and privatised state-owned enterprises, are argued to have a lack of “auditing, transparency and accountability” and have inherently “poor management and weak financial discipline” (Gomez and Jomo, 1997, p.76 and p.77). They assert that many government contracts are awarded to politically connected firms without competitive bidding. Some of the companies do not have prior experience or the necessary skills in the projects awarded to them.

Based on the literature discussed above, participants were asked to indicate their agreement or disagreement with eight statements about: (1) business dealings in Malaysia; (2) the importance of political connections in business dealings; and (3) the characteristics of politically connected firms (refer to Exhibit 4.3). Participants indicated their responses on 7-point Likert scales ranging from 7 = Strongly agree to 1 = Strongly disagree with 4 = Neither agree or disagree as the midpoint.

**Exhibit 4.2: Questions to assess participants' perceptions of political connections**

1. In Malaysia, the strength of the relationship between parties to a contract always influences the determination of contract terms.
2. In Malaysia, any breach of contract case filed by any party to a contract will be dealt with promptly and unbiasedly by the relevant authorities or court.
3. In Malaysia, the likelihood of success of any business dealing depends more on who you know rather than what you know.
4. In Malaysia, the likelihood of the success of a tender for any government project depends on the strength of connection to political leaders who are currently in power.
5. In Malaysia, firms that are connected to political leaders who are currently in power are less transparent in their financial reporting compared to unconnected firms.
6. In Malaysia, firms that are connected to political leaders who are currently in power have weaker corporate governance systems compared to unconnected firms.
7. In Malaysia, firms that are connected to political leaders who are currently in power are less transparent in business dealings compared to unconnected firms.
8. In Malaysia, firms that are connected to political leaders who are currently in power have weaker internal control systems compared to unconnected firms.

#### **4.7 Professional Scepticism Scale**

The 30-item scale provided in the Section 2 is from the instrument developed by Hurtt (2010) to measure professional scepticism in auditors. She based the instrument on auditing standards, philosophy, consumer behaviour research and psychology. She validated the instrument using students and professional auditors. Eight out of the 30 items in the instrument are reverse scored (i.e., items 1, 10, 11, 16, 17, 19, 25 and 26). The scores for all 30 items are added to obtain the total score. A higher total score reflects greater scepticism.

Prior research provides evidence that the level of professional scepticism affects auditors' judgments (Grenier, 2010; Carpenter and Reimers, 2009; Hurtt, Eining and Plumlee, 2008; Chen, Kelly and Salterio, 2009; Fullerton and Durtschi, 2004). Hence, the scale is included as part of the research instrument in order to control for potential differences in professional scepticism among the auditors who participated in this research.

#### **4.8 Participants and Incentive to Participate in the Experiment**

A number of the tasks in the experiment, especially the determination of audit fees and allocation of audit effort are normally performed by auditors in a more senior rank such as audit partners or audit managers. Discussions with a number of accounting academics and practitioners confirm this. Therefore, the target group of participants for this experiment is mainly audit partners and audit managers from Big 4, mid-size and small audit firms in Malaysia. Audit seniors who indicated they are familiar with the determination of audit fees and allocation of audit hours were also allowed to participate in this research.

Participants were recruited via three approaches. First, the researcher approached 15 of his personal contacts who are currently working in audit firms in Malaysia directly and invited them to participate in the research. The initial contact was made through emails and phone calls. They were informed about the purpose and the background of the research and were provided with an invitation letter (refer to Appendix 1). Those who agreed to participate were provided with a research instrument together with an information sheet, a consent form, a voucher payment form and postage prepaid self addressed envelope (Refer to Appendix 1 and Appendix 2).

Second, the researcher requested assistance from 7 his personal contacts to invite auditors in their firm to participate in the research. For this purpose, the contacts were provided with an introductory letter and an invitation letter. The introductory letter emphasised that the contacts should make it clear to the potential participants they approach that participation in the study is completely voluntary. The contacts were requested to forward the invitation letter to the potential participants. Those interested in participating were required to contact the researcher directly.

Third, a list of 30 audit firms and their contact details were randomly selected from the database of the Malaysian Accounting Institute's (MIA) website. The researcher then contacted the firms via email. Similar to the second approach, the contact person was provided with an introductory letter and an invitation letter to be forwarded to potential participants who could contact the researcher directly if they were willing to participate.

Auditors who participated in the research received a shopping voucher worth RM100 (Ringgit Malaysia 100) in appreciation of their time and effort expended in

completing the research instrument. Two reasons are provided to justify the payment of an incentive to the participants. First, the participants needed to perform a rigorous analysis of the client and make various judgements. It took approximately 40-50 minutes to complete the instrument. The objectives of this research can only be achieved if all participants are committed when they are completing the instrument. They would be more committed if paid an incentive. Second, other auditing behavioural studies often pay similar incentives to participants (e.g., Coram, Monroe and Woodliff, 2009; Chung, Cohen and Monroe, 2008; Monroe and Ng, 2000).

#### **4.9 Ethics Approval**

It is a requirement of the Human Research Ethics Committee of The Australian National University that any research involving human participants needs to be approved by the committee prior to commencement. Ethics approval was obtained prior to commencing data collection. The research has been conducted in accordance to the approval received from the Human Research Ethics Committee. No issues or problems relating to ethical conduct arose during the course of this research.

#### **4.10 Summary**

This chapter explains the research method used in the research. A 1x3 between-subjects research design is used. The independent variable is the client's political connections, which is manipulated at three levels: ruling party connections, opposition party connections and no connections. The chapter also discussed the development of the case materials used in the research. It also explains the administration of the experiment and the tasks performed by participants. Then, the

chapter describes the manipulation checks, the measures of participants' perceptions of political connections and the professional scepticism scale included in the research instrument. The final part of the chapter discusses the research ethics approval obtained for the research with particular emphasis on the recruitment of participants and payment of an incentive. The results of this research are discussed in the next chapter.



# CHAPTER 5

## Results

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### 5.1 Introduction

This chapter describes the results of the experiment. It first provides descriptive statistics about the auditors who participated in this research. Section 5.3 discusses the results of manipulation checks. Sections 5.4 to 5.9 discuss the data analysis and the results of hypotheses testing for H1 to H6. Section 5.10 discusses additional analyses using structural equation modelling. Section 5.11 summarises the chapter.

### 5.2 Participants' Profile

Table 5.1 contains descriptive statistics about the auditors who participated in this study. In total, 89 auditors from Big 4 and Non-Big 4 firms in Malaysia participated in this study. Three responses are excluded from the analysis because two cases were completed by junior auditors and one response is significantly incomplete. The final sample consists of 86 auditors. As discussed in Section 4.8, the nature of the tasks in the experiment requires more experienced auditors as participants, mainly audit managers and audit partners. However, audit seniors who indicate that they are familiar with the tasks in the experiment are included in this research.

In total, 22 audit partners, 57 audit managers and 7 audit seniors participated in the study. The average years of audit experience for participants are 10.76 years, 11.63 years and 12.17 years in the ruling party connections, opposition party connections and no political connections group respectively. The figures indicate that, on average, the participants have sufficient audit experience to perform the tasks in

the experiment. The average total score for the professional scepticism measure is 141 for participants in the ruling party connections group, 137 for participants in the opposition party connections group and 135 for participants in the no political connections group. The professional scepticism score is based on participant's responses to a 30-item professional scepticism scale developed by Hurtt (2010). The scale scores can range from 30 to 180 point. A higher total score reflects greater scepticism.

**Table 5.1 Demographics of the Participants**

		Ruling Party Connections	Opposition Party Connections	No Political Connection
Number of participants		35	30	21
Average Age		35.63	35.80	36.81
Gender	Male	19 (54.3%)	19 (63.3%)	16 (76.2%)
	Female	16 (45.7%)	11 (36.7%)	5 (23.8%)
Average years of work experience		12.55 years	12.39 years	13.07 years
Average years of audit experience		10.76 years	11.63 years	12.17 years
Type of firm	Big 4	18 (51.4%)	21 (70%)	16 (76.2%)
	Non-Big 4	17 (48.6%)	9 (30%)	5 (23.8%)
Level in Firm	Partner	9 (25.7%)	8 (26.7%)	5 (23.8%)
	Manager	22 (62.8%)	20 (66.7%)	15 (71.4%)
	Senior	4 (11.4%)	2 (6.6%)	1 (4.8%)
Average self-rated percentage of audit experience from auditing clients in the construction industry (Minimum = 0%, Maximum = 100%)		0.27	0.16	0.22
Professional Qualification	Yes	31 (88.6%)	30 (100%)	21 (100%)
	No	4 (11.4%)	0	0
University/college degree(s) or other university/college qualification(s)	Local	18 (51.4%)	13 (43.3%)	11 (52.4%)
	Overseas	11 (31.4%)	15 (50%)	8 (38.1%)
	No	6 (17.1%)	2 (6.7%)	2(9.5%)
Worked or studied outside Malaysia	Yes	12 (34.3%)	19 (63.3%)	9 (42.9%)
	No	23 (65.7%)	11 (36.7%)	12 (57.1%)
English as a first/native language	Yes	5 (14.3%)	8 (26.7%)	16 (76.2%)
	No	30 (85.7%)	22 (73.3%)	5 (23.8%)
Average self rated English language proficiency (1 = Very Poor, 7 = Very Good)		5.60	5.60	5.04
Race/ethnicity	Malay	18 (51.4%)	12 (40%)	9 (42.9%)
	Chinese	16 (45.7%)	16 (53.3%)	10 (47.6%)
	Indian	0	1 (3.3%)	1 (4.8%)
	Other	1 (2.9%)	1 (3.3%)	1 (4.8%)
Professional Scepticism Score <sup>1</sup>		141	137	135

<sup>1</sup> The professional scepticism score is based on participant's responses to a 30-item professional scepticism scale developed by Hurr (2010). The scale scores can range from 30 to 180 point. A higher total score reflects greater scepticism.

### 5.3 Manipulation Checks

Participants are considered to have passed the manipulation checks if they responded correctly to the two manipulation check questions or they listed political connections as a factor that increases or decreases a client's business risk. Of the 86 auditors who participated in the experiment, four failed the manipulation checks. The results reported in the remainder of the chapter for all hypotheses remain unchanged if the participants that failed the manipulation checks are excluded from the analysis. Hence, the results presented in this thesis include all 86 responses.

The two manipulation check questions asked participants to indicate their agreement or disagreement with two statements: (1) "Ramlee Ahmad (the CEO) has a very close relationship to the country's top political leaders who are currently in power"; and (2) "The majority of BCC board members have a very close relationship to the country's top political leaders who are currently in power". Participants indicated their response on a 7-point Likert scale ranging from 7 = Strongly agree to 1 = Strongly disagree with 4 = Neither agree or disagree as the midpoint.

ANOVA is used to examine whether there are significant differences in participants' responses to the questions. The results of these tests are presented in Table 5.2 and Table 5.3.

**Table 5.2: Manipulation Checks – Statement 1****Panel A: Descriptive Statistics**

Types of Political Connections	N	Mean	Standard Deviation
Ruling Party Connections	35	5.857	1.264
Opposition Party Connections	30	3.367	2.236
No Political Connections	21	4.143	1.062

**Panel B: ANOVA Results**

Source	Type III Sum of Squares	Df	Mean Square	F	Significance (one-tailed)
Corrected Model	105.258	2	52.629	19.962	0.000
Intercept	1631.314	1	1631.314	610.390	0.000
<b>Main effect:</b>					
Political Connections	105.258	2	52.629	19.692	0.000
Error	221.824	83	2.673		
Total	2123.000	86			
Corrected Total	327.081	85			

The dependent variable is participant's agreement or disagreement with a statement that "Ramlee Ahmad (the CEO) has a very close relationship to the country's top political leaders who are currently in power". Participant's indicated the agreement or disagreement on a 7-point scale anchored by 1 = Strongly disagree and 7 = Strongly agree with 4 = Neither agree or disagree as the midpoint. Political Connections is a categorical variable with three categories, i.e., ruling party connections, opposition party connections and no connections. For the ruling party connections category, participants are informed that five out of seven board of directors, including the CEO, have a very close relationship with the country's top political leaders at the federal level who are currently in power. For the opposition party connections category, participants are informed that five out of seven board members, including the CEO, have a very close relationship with the country's top opposition leaders at the federal level. In the no connections category, the statement about the client's political connections is omitted from the materials provided to participants.

**Table 5.3: Manipulation Checks – Statement 2**

**Panel A: Descriptive Statistics**

Types of Political Connections	N	Mean	Standard Deviation
Ruling Party Connections	35	5.743	1.482
Opposition Party Connections	30	3.467	2.330
No Political Connections	21	4.047	1.024

**Panel B: ANOVA Results**

Source	Type III Sum of Squares	Df	Mean Square	F	Significance (one-tailed)
Corrected Model	90.291	2	45.145	14.804	0.000
Intercept	1604.691	1	1604.691	526.222	0.000
<b>Main effect:</b>					
Political Connections	90.291	2	45.145	14.804	0.000
Error	253.105	83	3.049		
Total	2112.000	86			
Corrected Total	343.395	85			

The dependent variable is participant's agreement or disagreement with a statement that "The majority of BCC board members have a very close relationship to the country's top political leaders who are currently in power". Participant's indicated the agreement or disagreement on a 7-point scale anchored by 1 = Strongly disagree and 7 = Strongly agree with 4 = Neither agree or disagree as the midpoint. Political Connections is a categorical variable with three categories, i.e., ruling party connections, opposition party connections and no connections. For the ruling party political connections category, participants are informed that five out of seven board of directors, including the CEO, have a very close relationship with the country's top political leaders at the federal level who are currently in power. For the opposition party connections category, participants are informed that five out of seven board members, including the CEO, have a very close relationship with the country's top opposition leaders at the federal level. In the no connections category, the statement about the client's political connections is omitted from the materials provided to participants.

The ANOVA results reported in Table 5.2, Panel B and 5.3, Panel B, indicate significant main effect for a client's political connections on auditors' responses to the first and second statements. Participants' responses to the two statements are as expected (Refer to Section 4.5). The means for participants in ruling party connections group for statement one and statement two are 5.857 and 5.743 respectively. For auditors in the no political connections group, the means for statement one and



statement two are 4.143 and 4.047 respectively. The means for those in the opposition party connections group are 3.367 for statement 1 and 3.467 for statement 2.

#### **5.4 Data Analysis and Results for Hypothesis 1**

Hypothesis 1 addresses the issue of whether auditors identify a client's political connections as a factor that increases or decreases the client's business risk. Chi-square tests of proportions are used to test H1. Recall that H1 predicts that political connections are more likely to be identified as a factor that decreases a client's business risk for a client with ruling party connections compared to a client with opposition party connections. H1 also predicts that political connections are more likely to be identified as a factor that increases a client's business risk for a client with opposition party connections compared to a client with ruling party connections. The results of the Chi-square tests of proportions are presented in Table 5.4.

**Table 5.4: Identifying Political Connections as a Factor that Decreases Business Risk**

**Panel A: Identifying Political Connections as a Factor that Decreases Business Risk and Types of Political Connections Crosstabulation**

			Political Connections	
			Ruling Party Connections	Opposition Party Connections
<b>Listing of political connection as a factor that decreases business risk</b>	No	Count	11	28
		% within political connection	31.4%	93.3%
	Yes	Count	24	2
		% within political connection	68.6%	6.7%
<b>Total</b>		Count	35	35
		% within political connection	100.0%	100.0%

**Panel B: Chi-Square Tests**

	Value	df	Significance (one-tailed)
Pearson Chi-Square	23.794	1	0.000
Continuity Correction	23.279	1	0.000

The crosstabulation of the identification of political connections as a factor that decreases business risk and the types of political connections is reported in Table 5.4, Panel A. The crosstabulation results indicate that 68.6% of participants in the ruling party connections group identify political connections as a factor that decreases a client’s business risk while only 6.7% of participants in the opposition party connections group identify political connections as a factor that decreases a client’s business risk. The results of the Chi-square test reported in Table 5.4, Panel B show that the proportion of participants in the ruling party connections group who identify political connections as a factor that decreases a client’s business risk is significantly higher than the proportion of participants in the opposition party connections group

who identify political connections as a factor that decreases a client's business risk (continuity correction = 23.279,  $p = 0.000$ ).<sup>22</sup>

The crosstabulation of the identification of political connections as a factor that increases business risk and the types of political connections is reported in Table 5.5, Panel A. The results indicate that 83.3% of participants in the opposition party connections group identify political connections as a factor that increases a client's business risk while 51.4% auditors in the ruling party connections group identify political connections as a factor that increases a client's business risk. The results of the Chi-square test reported in Table 5.5, Panel B show that the proportion of participants in the opposition party connections group who identify political connections as a factor that increases a client's business risk is significantly higher than the proportion of participants in the ruling party connections group who identify political connections as a factor that increases a client's business risk (continuity correction = 5.988,  $p = 0.007$ ).

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<sup>22</sup> According to Pallant (2007, p.216), the Yates' continuity correction should be used if a chi-square proportion test involves a 2 by 2 table.

**Table 5.5: Identifying Political Connections as a Factor that Increases Business Risk**

**Panel A: Identifying Political Connections as a Factor that Increases Business Risk and Types of Political Connections Crosstabulation**

			Political Connections	
			Ruling Party Connections	Opposition Party Connections
Listing of political connection as a factor that increases business risk	No	Count	17	5
		% within political connection	48.6%	16.7%
	Yes	Count	18	25
		% within political connection	51.4%	83.3%
Total		Count	35	30
		% within political connection	100.0%	100.0%

**Panel B: Chi-Square Tests**

	Value	df	Significance (one-tailed)
Pearson Chi-Square	7.344	1	0.004
Continuity Correction	5.988	1	0.007

Overall, the results of the Chi-square proportion tests reported in Table 5.4 and Table 5.5 indicate that auditors in the ruling party (opposition party) connections group are more likely to identify political connections as a factor that decreases (increases) a client’s business risk compared to participants in the opposition party (ruling party) connections group, thereby supporting H1.

## 5.5 Data Analysis and Results for Hypothesis 2

Hypothesis 2 addresses the effect of a client's political connections on auditors' assessment of a client's business risk. The dependent variable is the participant's assessment of a client's business risk, which is measured on a 7-point scale where 1 = Very Low Risk and 7 = Very High Risk.

Although the effects of firm type on business risk assessment is not the main focus of hypothesis 2, firm type is included as an independent variable to control for any potential differences in the judgements of Big-4 and Non-Big-4 auditors. Initial analysis indicates that professional scepticism measure is not significant. Hence, it is omitted from the subsequent analyses. An ANOVA is conducted with political connections and firm type as the independent variables. The results are presented in Table 5.6.



**Table 5.6: Business Risk Assessment****Panel A: Descriptive Statistics**

Types of Political Connections	N	Mean	Standard Deviation	Adjusted Mean
Ruling Party Connections	35	5.363	0.720	5.361
Opposition Party Connections	30	5.425	0.751	5.395
No Political Connections	21	5.274	0.698	4.974

**Panel B: ANOVA Results**

Source	Type III Sum of Squares	Df	Mean Square	F	Significance (one-tailed)
Corrected Model	5.696	5	1.139	2.379	0.023
Intercept	1847.823	1	1847.823	3858.300	0.000
<b>Main effect:</b>					
Political Connections	1.976	2	.988	2.063	0.067
Firm Type	4.033	1	4.033	8.422	0.003
Political Connections x Firm Type	2.954	2	1.477	3.084	0.026
Error	38.314	80	.479		
Total	2518.047	86			
Corrected Total	44.010	85			

**Panel C: Planned Comparisons**

Planned Comparison Relating to the Business Risk between:	Mean Difference	Standard Error	Significance (one-tailed)
Ruling Party Connections and No Political Connections	0.387	0.212	0.036
Ruling Party Connections and Opposition Party Connections	-0.034	0.181	0.427
Opposition Party Connections and No Political Connections	0.421	0.225	0.033

Panel A shows the means and the adjusted means for the dependent variables. The adjusted means are the means from an ANOVA conducted with Political Connections and Firm Type as the independent variables. Firm Type is included in the model as a control variable. The adjusted means are the original means that have been adjusted for the effect of the control variable in the model. The mean difference reported in Panel C is the difference in the adjusted means. The dependent variable is Business Risk, which is measured by the participant's assessments of business risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk. Political Connections is a categorical variable with three categories, i.e., ruling party connections, opposition party connections and no connections. For the ruling party connections category, participants are informed that five out of seven board of directors, including the CEO, have a very close relationship with the country's top political leaders at the federal level who are currently in power. For the opposition party connections category, participants are informed that five out of seven board members, including the CEO, have a very close relationship with the country's top opposition leaders at the federal level. In the no connections category, the statement about the client's political connections is omitted from the materials provided to participants. Firm Type is a categorical variable that is coded as 1 for participants from a Big 4 firm and 0 for participants from a Non-Big 4 firm.

Panel A of Table 5.6 shows the means and the adjusted means for the dependent variables. The adjusted means are the means from an ANOVA conducted with Political Connections and Firm Type as the independent variables. Firm type is included in the model as a control variable. The adjusted means are the original means that have been adjusted for the effect of the control variable in the model. The mean difference reported in Panel C of Table 5.6 is the difference in the adjusted means.

The ANOVA results reported in Table 5.6, Panel B show a significant main effect for a client's political connections on participants' assessment of a client's business risk ( $F = 2.063$ ,  $p = 0.067$ ). Recall that H2a predicts that auditors' average assessment of business risk will be higher for a client with ruling party connections compared to a client with no political connections. Planned comparisons are conducted using a simple contrast (Table 5.6, Panel C). A planned contrast between the ruling party connections and no political connections groups shows that the average assessment of business risk for a client with ruling party connections is higher than for a client with no political connections (mean difference = 0.387,  $p = 0.036$ ), which supports H2a.

H2b predicts that the average assessment of business risk will be higher for a client with opposition party connections compared to that for a client with no political connections. The results of the planned comparison reported in Table 5.6, Panel C indicate that the average assessment of business risk is significantly higher for a client with opposition party connections compared to a client with no political connections (mean difference = 0.421,  $p = 0.033$ ), which supports H2b.

H2c proposes that there will be no difference in auditors' average assessment of business risk for a client with ruling party connections compared to a client with opposition party connections. As shown in Table 5.6, Panel C, the planned comparison between the ruling party connections and opposition party connections groups is not significant ( $p = 0.427$ ). Therefore, H2c is supported.

### 5.6 Data Analysis and Results for Hypothesis 3

Hypothesis 3 addresses the effect of a client's political connections on auditors' assessments of fraud risk. The dependent variables are the auditor's fraud risk assessments, which are measured by two variables. The first dependent variable is Fraud Risk, which is the participant's assessment of fraud risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk. The second dependent variable is Probability Fraud Risk, which is the participant's allocation of the probability that fraudulent financial reporting causes the fluctuation in the gross profit ratio.

Although the effect of firm type on fraud risk assessment is not the main focus in the analysis of Hypothesis 3, firm type is included as an independent variable to control for any potential differences in the judgements of Big-4 and Non-Big-4 auditors. Another variable, Business Risk, which is the participant's assessment of business risk on a 7-point scale where 1 = Very Low Risk and 7 = Very High Risk, is included as a covariate. Initial analysis indicates that professional scepticism measure is not significant. Hence, it is not included as a covariate in the subsequent analyses. A MANCOVA is conducted with political connections and firm type as the independent variables and business risk assessment as a covariate. The results are presented in Table 5.7.

**Table 5.7: Fraud Risk Assessments**

**Panel A: Descriptive Statistics (Fraud Risk)**

Types of Political Connections	N	Mean	Standard Deviation	Adjusted Mean
Ruling Party Connections	35	5.143	0.912	5.138
Opposition Party Connections	30	5.267	0.828	5.179
No Political Connections	21	4.833	1.218	4.486

**Panel B: Descriptive Statistics (Probability Fraud Risk)**

Types of Political Connections	N	Mean	Standard Deviation	Adjusted Mean
Ruling Party Connections	35	0.403	0.180	0.402
Opposition Party Connections	30	0.459	0.195	0.456
No Political Connections	21	0.358	0.209	0.336

**Panel C: MANCOVA Results (Multivariate Tests)**

Source of Variance	Wilks' $\lambda$	F	Significance (one-tailed)
<u>Independent Variable</u>			
Political Connections	0.897	2.189	0.037
Firm Type	0.864	6.135	0.002
Political Connections x Firm Type	0.926	1.537	0.097
<u>Covariate</u>			
Business Risk	0.912	3.778	0.014

Panel D: Univariate Results

Source	DV	Type III Sum of Squares	Df	Mean Square	F	Significance (one-tailed)
Model	Fraud Risk	23.480	6	3.913	5.450	0.000
	Probability Fraud Risk	0.442	6	0.074	2.098	0.032
<u>Independent Variable</u>						
Political Connections	Fraud Risk	5.195	2	2.597	3.618	0.016
	Probability Fraud Risk	0.134	2	0.067	1.907	0.078
Firm Type	Fraud Risk	7.483	1	7.483	10.423	0.001
	Probability Fraud Risk	0.038	1	0.038	1.078	0.151
Political Connections x Firm Type	Fraud Risk	3.573	2	1.787	2.488	0.045
	Probability Fraud Risk	0.029	2	0.014	0.411	0.332
<u>Covariate</u>						
Business Risk	Fraud Risk	5.357	1	5.357	7.461	0.004
	Probability Fraud Risk	0.157	1	0.157	4.482	0.019
Error	Fraud Risk	56.721	79			
	Probability Fraud Risk	2.775	79			



**Panel E: Planned Comparisons**

<b>Planned Comparison Relating to the Fraud Risk between:</b>	<b>Mean Difference</b>	<b>Standard Error</b>	<b>Significance (one-tailed)</b>
Ruling Party Connections and No Political Connections	0.652	0.265	0.008
Ruling Party Connections and Opposition Party Connections	-0.041	0.221	0.433
Opposition Party Connections and No Political Connections	0.693	0.281	0.008

<b>Planned Comparison Relating to the Probability Fraud Risk between:</b>	<b>Mean Difference</b>	<b>Standard Error</b>	<b>Significance (one-tailed)</b>
Ruling Party Connections and No Political Connections	0.066	0.059	0.131
Ruling Party Connections and Opposition Party	-0.054	0.049	0.137
Opposition Party Connections and No Political Connections	0.121	0.062	0.028

Panel A and Panel B show the means and the adjusted means for the dependent variables. The adjusted means are the means from the MANCOVA conducted with Political Connections and Firm Type as the independent variables and Business Risk as a covariate. The adjusted means are the original means that have been adjusted for the effect of the control variables in the model. The mean difference reported in Panel E is the difference in the adjusted means. The dependent variables are the participant's fraud risk assessments, which are measured by two variables: (1) Fraud Risk is the participant's assessment of fraud risk on a 7-point scale where 1 = Very Low Risk and 7 = Very High Risk; and (2) Probability Fraud Risk is the participant's allocation of the probability of a fraudulent financial reporting as a factor that causes a fluctuation in the gross profit ratio. Political connections is a categorical variable with three categories, i.e., ruling party connections, opposition party connections and no connection. For the ruling party connections category, participants are informed that five out of seven board of directors, including the CEO, have a very close relationship with the country's top political leaders at the federal level who are currently in power. For the opposition party connections category, participants are informed that five out of seven board members, including the CEO, have a very close relationship with the country's top opposition leaders at the federal level. In the no connection category, the statement about the client's political connections is omitted from the materials provided to participants. Firm Type is a categorical variable that is coded as 1 for participants from a Big 4 firm and 0 for participants from a Non-Big 4 firm. Firm Type is a control variable that is used to control for any potential differences in the judgement of auditors from Big 4 and Non-Big 4 firms. Business Risk is the participant's assessment of business risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk.

Panel A and Panel B of Table 5.7 show the means and the adjusted means for the dependent variables. The adjusted means are the means from the MANCOVA conducted with Political Connections and Firm Type as the independent variables and Business Risk as a covariate. The adjusted means are the original means that have been adjusted for the effect of the control variables in the model. The mean difference reported in Panel E of Table 5.7 is the difference in the adjusted means.

The MANCOVA results reported in Panel C of Table 5.7 show a significant main effect for client's political connection on participants' assessments of fraud risk ( $F = 2.189, p = 0.037$ ). The covariate, business risk assessment, has a significant effect on the assessments of fraud risk ( $F = 3.778, p = 0.014$ ). The results of univariate analyses reported in Panel D of Table 5.7 indicate that the effect of political connections on fraud risk assessments is significant for both measures of the dependent variables, i.e., Fraud Risk ( $F = 3.618, p = 0.016$ ) and Probability Fraud Risk ( $F = 1.907, p = 0.078$ ).

H3a predicts that auditors' average assessment of fraud risk will be higher for a client with ruling party connections compared to a client with no political connections. Planned comparisons are conducted using a simple contrast and the results are presented in Panel E of Table 5.7. The results of planned comparisons between the ruling party connections and no political connections groups indicate that the Fraud Risk variable is significant (mean difference = 0.652,  $p = 0.008$ ) while the Probability Fraud Risk variable is not significant (mean difference = 0.066,  $p = 0.131$ ). Overall, the results of the planned comparisons show that the average assessment of fraud risk is significantly higher for a client with ruling party connections compared to a client with no political connections, which supports H3a.

H3b proposes that auditors' average assessment of fraud risk will be higher for a client with opposition party connections compared to a client with no political connections. The results of planned comparisons (Table 5.7, Panel E) indicate that the average assessment of fraud risk is significantly higher for a client with opposition party connections compared to a client with no political connections. These results are robust for both fraud risk measures, i.e., Fraud Risk (mean difference = 0.693,  $p = 0.008$ ) and Fraud Risk Probability (mean difference = 0.121,  $p = 0.028$ ). Overall, the

results of the planned comparisons show that the average assessment of fraud risk is significantly higher for a client with opposition party connections compared to a client with no political connections, thereby supporting H3b.

H3c predicts that there will be no difference in the average assessment of fraud risk for a client with ruling party connections compared to the average assessment for a client with opposition party connections. The results of a planned comparison (Table 5.7, Panel E) between the ruling party connections and opposition party connections groups indicate that both the Fraud Risk variable and Fraud Risk Probability variable are not significantly different (mean difference = -0.041,  $p = 0.433$  and mean difference = -0.054,  $p = 0.137$  respectively). There is no significant difference in the average assessment of fraud risk for a client with ruling party connections in comparison to a client with opposition party connections, which supports H3c.

## 5.7 Data Analysis and Results for Hypothesis 4

Hypothesis 4 considers the effect of a client's political connections on auditors' assessments of the client's error risk. The dependent variables are the auditor's error risk assessments, which are measured by two variables. The first measure is Error Risk, which is the participant's assessment of error risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk. The second measure is Probability Error Risk, which is the participant's allocation of the probability that an unintentional error causes the fluctuation in the gross profit ratio.

Although the effect of firm type on error risk assessment is not the main focus in the analysis of Hypothesis 4, firm type is included as an independent variable to control for any potential differences in the judgements of Big-4 and Non-Big-4 auditors. Another variable, Business Risk, which is the participant's assessment of business risk on a 7-point scale where 1 = Very Low Risk and 7 = Very High Risk, is included as a covariate. Initial analysis indicates that professional scepticism measure is not significant. Hence, it is not included as a covariate in the subsequent analyses. A MANCOVA is conducted with political connections and firm type as the independent variables and business risk assessment as a covariate. The results are presented in Table 5.8.

**Table 5.8: Error Risk Assessments**

**Panel A: Descriptive Statistics for Error Risk**

Types of Political Connections	N	Mean	Standard Deviation	Adjusted Mean
Ruling Party Connections	35	4.857	0.974	4.858
Opposition Party Connections	30	5.033	1.098	4.799
No Political Connections	21	4.571	1.207	4.131

**Panel B: Descriptive Statistics for Probability Error Risk**

Types of Political Connections	N	Mean	Standard Deviation	Adjusted Mean
Ruling Party Connections	35	0.353	0.157	0.354
Opposition Party Connections	30	0.278	0.151	0.301
No Political Connections	21	0.296	0.175	0.262

**Panel C: MANCOVA Results (Multivariate Tests)**

Source of Variance	Wilks' $\lambda$	F	Significance (one-tailed)
<u>Independent Variable</u>			
Political Connections	0.881	2.547	0.021
Firm Type	0.850	6.866	0.001
Political Connections x Firm Type	0.841	3.525	0.005
<u>Covariate</u>			
Business Risk	0.899	4.359	0.008

**Panel D: Univariate Results**

<b>Source</b>	<b>DV</b>	<b>Type III Sum of Squares</b>	<b>Df</b>	<b>Mean Square</b>	<b>F</b>	<b>Significance (one-tailed)</b>
<b>Model</b>	Error Risk	23.701	6	3.950	4.142	0.001
	Probability Error Risk	0.407	6	0.068	2.974	0.011
<u><b>Independent Variable</b></u>						
<b>Political Connections</b>	Error Risk	5.766	2	2.883	3.023	0.027
	Probability Error Risk	0.097	2	0.048	2.124	0.063
<b>Firm Type</b>	Error Risk	13.184	1	13.184	13.826	0.000
	Probability Error Risk	0.004	1	0.004	0.156	0.347
<b>Political Connections x Firm Type</b>	Error Risk	9.876	2	4.938	5.178	0.004
	Probability Error Risk	0.091	2	0.045	1.988	0.072
<u><b>Covariate</b></u>						
<b>Business Risk</b>	Error Risk	0.239	1	0.239	0.250	0.618
	Probability Error Risk	0.198	1	0.198	8.659	0.002
<b>Error</b>	Error Risk	75.334	79	0.954		
	Probability Error Risk	1.802	79	0.023		



**Panel E: Planned Comparisons**

<b>Planned Comparison Relating to the Error Risk between:</b>	<b>Mean Difference</b>	<b>Standard Error</b>	<b>Significance (one-tailed)</b>
Ruling Party Connections and No Political Connections	0.727	0.306	0.010
Ruling Party Connections and Opposition Party Connections	0.059	0.255	0.414
Opposition Party Connections and No Political Connections	0.668	0.324	0.021

<b>Planned Comparison Relating to the Probability Error Risk between:</b>	<b>Mean Difference</b>	<b>Standard Error</b>	<b>Significance (one-tailed)</b>
Ruling Party Connections and No Political Connections	0.092	0.047	0.029
Ruling Party Connections and Opposition Party Connections	0.053	0.039	0.091
Opposition Party Connections and No Political Connections	0.039	0.050	0.224

Panel A and Panel B show the means and the adjusted means for the dependent variables. The adjusted means are the means from the MANCOVA conducted with Political Connections and Firm Type as the independent variables and Business Risk as a covariate. The adjusted means are the original means that have been adjusted for the effect of the control variables in the model. The mean difference reported in Panel E is the difference in the adjusted means. The dependent variables are the participant’s error risk assessments, which are measured by two variables: (1) Error Risk is the participant’s assessment of error risk on a 7-point scale where 1 = Very Low Risk and 7 = Very High Risk; and (2) Probability Error Risk is the participant’s allocation of the probability of an unintentional error as a factor that causes a fluctuation in the gross profit ratio. Political Connections is a categorical variable with three categories, i.e., ruling party connections, opposition party connections and no connection. For the ruling party connections category, participants are informed that five out of seven board of directors, including the CEO, have a very close relationship with the country’s top political leaders at the federal level who are currently in power. For the opposition party connections category, participants are informed that five out of seven board members, including the CEO, have a very close relationship with the country’s top opposition leaders at the federal level. In the no connection category, the statement about the client’s political connections is omitted from the materials provided to participants. Firm Type is a categorical variable that is coded as 1 for participants from a Big 4 firm and 0 for participants from a Non-Big 4 firm. Business Risk is the participant’s assessment of business risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk.

Panel A and Panel B of Table 5.8 show the means and the adjusted means for the dependent variables. The adjusted means are the means from the MANCOVA conducted with Political Connections and Firm Type as the independent variables and Business Risk as a covariate. The adjusted means are the original means that have been adjusted for the effect of the control variables in the model. The mean difference reported in Panel E of Table 5.8 is the difference in the adjusted means.

The MANCOVA results reported in Table 5.8, Panel C, show a significant main effect for a client's political connection on participants' assessments of error risk ( $F = 2.547, p = 0.021$ ). The covariate, business risk assessment, has a significant effect on the assessment of error risk ( $F = 4.359, p = 0.008$ ). The results of the univariate analyses reported in Panel D of Table 5.8 indicate that the effect of political connections on error risk assessments is significant for both measures of the dependent variables, i.e., Error Risk ( $F = 3.023, p = 0.027$ ) and Probability Error Risk ( $F = 2.124, p = 0.063$ ).

H4a predicts that auditors' average assessment of error risk will be higher for a client with ruling party connections compared to the average assessment of error risk for a client with no political connections. Planned comparisons are conducted using a simple contrast and the results are presented in Panel E of Table 5.8. The results of planned comparisons between the ruling party connections and no political connections groups indicate that the average assessment of error risk is significantly higher for a client with ruling party connections compared to a client with no political connections. This result is robust for both measures of error risk assessments, i.e., Error Risk (mean difference = 0.727,  $p = 0.010$ ) and Probability Error Risk (mean difference = 0.092,  $p = 0.029$ ), hence supporting H4a.

H4b proposes that auditors' average assessment of error risk will be higher for a client with opposition party connections compared to that for a client with no political connections. The results of planned comparisons for Error Risk (Table 5.8, Panel E) indicate that the average assessment of error risk for a client with opposition party connections is significantly higher than for a client with no political connection (mean difference = 0.668,  $p = 0.021$ ) while the results of planned comparisons for

Probability Error Risk indicate no significant difference across the two groups. Overall, the results indicate that the average assessment of error risk is significantly higher for a client with opposition party connections compared to a client with no political connections, which supports H4b.

H4c predicts that auditors' average assessment of error risk will be higher for a client with ruling party connections compared to their average assessment of error risk for a client with opposition party connections. The results of planned comparisons between the ruling party connections and opposition party connections groups reported in Panel E of Table 5.8 indicate that the average assessment of error risk measured by Probability Error Risk is significantly higher for a client with ruling party connections compared to a client with opposition party connections (mean difference = 0.053,  $p=0.091$ ). However the planned comparison between the ruling party connections and opposition party connections groups for Error Risk is not significant (mean difference = 0.059,  $p = 0.414$ ). Overall, the results of the planned comparisons show that the average assessment of error risk for a client with ruling party connections is higher than for a client with opposition party connections, which supports H4c.

## 5.8 Data Analysis and Results for Hypothesis 5

Hypothesis 5 addresses the effect of a client's political connections on auditors' assessments of the audit effort required. The dependent variables are the auditor's assessments of audit effort required, measured by three variables. The first dependent variable is Effort, which is the auditor's assessment of the audit effort they would allocate for the audit of the client compared to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Lower Effort and 7 = Much higher effort. The second dependent variable is Hours, which is the participant's assessment of required audit hours they would allocate for the audit of the client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Fewer Hours and 7 = Much More Hours. The third dependent variable is Personnel, which is the participant's assessment of the mix of audit personnel participants they would allocate to the audit of the client compared to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Higher Proportion of Junior Auditor and 7 = Much Higher Proportion of Senior Auditor.

Although the effect of firm type on the assessment of the audit effort required is not the main focus in the analysis of H5, firm type is included as an independent variable to control for any potential differences in the judgements of Big-4 and Non-Big-4 auditors. Another variable, Business Risk, which is the participant's assessment of business risk on a 7-point scale where 1 = Very Low Risk and 7 = Very High Risk, is included as a covariate. Initial analysis indicates that professional scepticism measure is not significant. Hence, it is not included as a covariate in the subsequent analyses. A

MANCOVA is conducted with political connections and firm type as the independent variables and business risk assessment as a covariate. The results are presented in Table 5.9.

**Table 5.9: Required Audit Effort Assessments**

**Panel A: Descriptive Statistics for Effort**

Types of Political Connections	N	Mean	Standard Deviation	Adjusted Mean
Ruling Party Connections	35	5.514	0.853	5.512
Opposition Party Connections	30	5.733	0.907	5.702
No Political Connections	21	5.333	0.966	5.033

**Panel B: Descriptive Statistics for Hours**

Types of Political Connections	N	Mean	Standard Deviation	Adjusted Mean
Ruling Party Connections	35	5.514	0.742	5.514
Opposition Party Connections	30	5.633	0.890	5.569
No Political Connections	21	5.333	0.966	4.999

**Panel C: Descriptive Statistics for Personnel**

Types of Political Connections	N	Mean	Standard Deviation	Adjusted Mean
Ruling Party Connections	35	5.371	0.807	5.363
Opposition Party Connections	30	5.667	0.844	5.635
No Political Connections	21	5.238	1.044	4.808

**Panel D: MANCOVA Results (Multivariate)**

Source of Variance	Wilks' $\lambda$	F	Significance (one-tailed)
<u>Independent Variable</u>			
Political Connections	0.858	2.047	0.032
Firm Type	0.826	5.420	0.001
Political Connections x Firm Type	0.845	2.247	0.021
<u>Covariate</u>			
Business Risk	0.845	4.707	0.003



Panel E: Univariate Results

Source	DV	Type III Sum of Squares	Df	Mean Square	F	Significance (one-tailed)
Model	Effort	20.424	6	3.404	5.501	0.000
	Hours	17.180	6	2.863	5.105	0.000
	Personnel	16.015	6	2.669	4.119	0.001
<u>Independent Variable</u>						
Political Connections	Effort	4.118	2	2.059	3.327	0.021
	Hours	3.391	2	1.695	3.023	0.027
	Personnel	6.236	2	3.118	4.811	0.006
Firm Type	Effort	3.541	1	3.541	5.722	0.010
	Hours	4.527	1	4.527	8.072	0.003
	Personnel	9.789	1	9.789	15.106	0.000
Political Connections x Firm Type	Effort	4.060	2	2.030	3.280	0.022
	Hours	4.711	2	2.356	4.200	0.009
	Personnel	4.907	2	2.454	3.786	0.014
<u>Covariate</u>						
Business Risk	Effort	6.315	1	6.315	10.205	0.001
	Hours	3.879	1	3.879	6.917	0.005
	Personnel	0.004	1	0.004	0.007	0.468
Error	Effort	48.490	79	0.619		
	Hours	44.308	79	0.561		
	Personnel	51.195	79	0.648		

**Panel F: Planned Comparisons**

<b>Planned Comparison Relating to the Effort between:</b>	<b>Mean Difference</b>	<b>Standard Error</b>	<b>Significance (one-tailed)</b>
Ruling Party Connections and No Political Connections	0.479	0.246	0.028
Ruling Party Connections and Opposition Party Connections	-0.190	0.206	0.180
Opposition Party Connections and No Political Connections	0.669	0.261	0.006

<b>Planned Comparison Relating to the Hours between:</b>	<b>Mean Difference</b>	<b>Standard Error</b>	<b>Significance (one-tailed)</b>
Ruling Party Connections and No Political Connections	0.515	0.235	0.016
Ruling Party Connections and Opposition Party Connections	-0.055	0.196	0.389
Opposition Party Connections and No connections	0.570	0.248	0.012

<b>Planned Comparison Relating to the Personnel between:</b>	<b>Mean Difference</b>	<b>Standard Error</b>	<b>Significance (one-tailed)</b>
Ruling Party Connections and No Political Connections	0.555	0.252	0.016
Ruling Party Connections and Opposition Party Connections	-0.272	0.210	0.100
Opposition Party Connections and No Political Connections	0.827	0.267	0.002

Panel A, Panel B and Panel C show the means and the adjusted means for the dependent variables. The adjusted means are the means from the MANCOVA conducted with Political Connections and Firm Type as the independent variables and Business Risk as a covariate. The adjusted means are the original means that have been adjusted for the effect of the control variables in the model. The mean difference reported in Panel F is the difference in the adjusted means. The dependent variables are the participant's assessments of the required audit effort, which are measured by three variables: (1) Effort is the participant's assessment of the audit effort they would allocate for the audit of the client compared to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Lower Effort and 7 = Much higher effort; (2) Hours is the participant's assessment of required audit hours participants would allocate for the audit of the client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Fewer Hours and 7 = Much More Hours; (3) Personnel is the participant's assessment of the mix of audit personnel participants they would allocate to the audit of the client compared to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Higher Proportion of Junior Auditor and 7 = Much Higher Proportion of Senior Auditor. Political Connections is a categorical variable with three categories, i.e., ruling party connections, opposition party connections and no connection. For the ruling party connections category, participants are informed that five out of seven board of directors, including the CEO, have a very close relationship with the country's top political leaders at the federal level who are currently in power. For the opposition party connections category, participants are informed that five out of seven board members, including the CEO, have a very close relationship with the country's top opposition leaders at the federal level. In the no connection category, the statement about the client's political connections is omitted from the materials provided to participants. Firm Type is a categorical variable that is coded as 1 for participants from a Big 4 firm and 0 for participants from a Non-Big 4 firm. Firm Type is a control variable that is used to control for any potential differences in the judgement of auditors from Big 4 and Non-Big 4 firms. Business Risk is the participant's assessment of business risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk.

Panel A, Panel B and Panel C of Table 5.9 show the means and the adjusted means for the dependent variables. The adjusted means are the means from the MANCOVA conducted with Political Connections and Firm Type as the independent variables and Business Risk as a covariate. The adjusted means are the original means that have been adjusted for the effect of the control variables in the model. The mean difference reported in Panel F of Table 5.9 is the difference in the adjusted means.

The MANCOVA results reported in Panel D of Table 5.9 show a significant main effect for the client's political connection on auditors' assessments of the audit effort required ( $F = 2.047$ ,  $p = 0.032$ ). The covariate, business risk assessment, has a significant effect on the assessments of the required audit effort ( $F = 4.707$ ,  $p = 0.003$ ). The results of univariate analyses shown in Panel E of Table 5.9 indicate that the effect of political connections on the assessments of the required audit effort is significant for all three measures of audit effort, i.e., Effort ( $F = 3.327$ ,  $p = 0.021$ ), Hours ( $F = 3.023$ ,  $p = 0.027$ ) and Personnel ( $F = 4.811$ ,  $p = 0.006$ ).

H5a predicts that auditors' average assessment of audit effort required will be higher for a client with ruling party connections compared to a client with no political connections. Planned comparisons are conducted using a simple contrast and the results are presented in Panel F of Table 5.9. The results of a planned comparison between the ruling party connections and no political connections for all the three measures of the dependent variables are significant and in the same direction. For Effort, the mean difference is 0.479 and the p value is 0.028 (one-tailed). For Hours, the mean difference is 0.515 and the p value is 0.016 (one-tailed). For Personnel, the mean difference is 0.555 and the p value is 0.016 (one-tailed). Overall, the results of the planned comparisons show that the average assessment of required audit effort is

significantly higher for a client with ruling party connections compared to a client with no political connections. Therefore, H5a is supported.

H5b predicts that auditors' average assessment of the audit effort required will be higher for a client with opposition party connections than the average effort required for a client with no political connections. The results of planned comparisons (Table 5.9, Panel F) indicate that the average assessment of the audit effort required is significantly higher for a client with opposition party connections compared to a client with no political connections. These results are robust for all three measures of audit effort required, i.e., Effort (mean difference = 0.669,  $p = 0.006$ ), Hours (mean difference = 0.570,  $p = 0.012$ ) and Personnel (mean difference = 0.827,  $p = 0.002$ ). Overall, the results of the planned comparisons show that the average assessment of the audit effort required is significantly higher for a client with opposition party connections compared to a client with no political connections, which supports H5b.

H5c proposes that auditors' average assessment of the audit effort required will be higher for a client with ruling party connections compared to a client with opposition party connections. The results of planned comparisons (Table 5.9, Panel F) between the ruling party connections and opposition party connections groups indicate that the Personnel variable is weakly significant (mean difference = -0.273,  $p = 0.100$ ). The other two dependent variables, Effort and Hours, are not significant (mean difference = -0.190,  $p = 0.180$  and mean difference = -0.055 and  $p = 0.389$  respectively). The results provide weak support for H5c.

## 5.9 Data Analysis and Results for Hypothesis 6

Hypothesis 6 considers the effect of a client's political connections on auditors' audit fee decisions. The dependent variables are the auditor's audit fee decisions, which are measured by two variables. The first dependent variable is AFRelative, which is the participant's assessment of the audit fee that the client would be charged in comparison to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Lower Audit Fee and 7 = Much Higher Audit Fee. The second dependent variable is AFAmount, which is the participant's recommended monetary audit fee based on audit fee figures for two typical clients (i.e., clients with high and low risk of material misstatement respectively) in the same industry comparable in size and complexity.

Although the effect of firm type on the audit fee decision is not the main focus in the analysis of H6, firm type is included as an independent variable to control for any potential differences in the judgements of Big-4 and Non-Big-4 auditors. A number of covariates are included in the model. The first covariate is Business Risk, which is the auditor's assessment of business risk on a 7-point scale where 1 = Very Low Risk and 7 = Very High Risk. The second covariate is Fraud Risk, which is the auditor's assessment of fraud risk on a 7-point scale where 1 = Very Low Risk and 7 = Very High Risk. The third covariate is Error Risk, which is the auditor's assessment of error risk on a 7-point scale where 1 = Very Low Risk and 7 = Very High Risk. The fourth covariate is Perception (Q8a), which is the auditor's response to the question "In Malaysia, the strength of the relationship between parties to a contract always influence the determination of contract terms" anchored by 1= Strongly Disagree and 7 = Strongly Agree. The fifth covariate is Perception (Q8d), which is the auditor's response to the

question “In Malaysia, the likelihood of the success of a tender for any government projects depends on the strength of connections to political leaders who are currently in power” anchored by 1 = Strongly Disagree and 7 = Strongly Agree. Initial analysis indicates that professional scepticism measure is not significant. Hence, it is not included as a covariate in the subsequent analyses. A MANCOVA is conducted with political connections and firm type as the independent variables and the five covariates. The results are presented in Table 5.10.



**Table 5.10: Audit Fee Decisions**

**Panel A: Descriptive Statistics for AFRelative**

Types of Political Connections	N	Mean	Standard Deviation	Adjusted Mean
Ruling Party Connections	35	5.429	0.884	5.347
Opposition Party Connections	30	5.467	1.001	5.247
No Political Connections	21	5.238	0.889	5.520

**Panel B: Descriptive Statistics for AFAmount**

Types of Political Connections	N	Mean	Standard Deviation	Adjusted Mean
Ruling Party Connections	35	87041.057	18382.477	88370.021
Opposition Party Connections	30	85200.000	14116.266	80380.370
No Political Connections	21	81666.667	18995.614	78323.181

**Panel C: MANCOVA Results (Multivariate)**

Source of Variance	Wilks' $\lambda$	F	Significance (one-tailed)
<u>Independent Variable</u>			
Political Connections	0.911	1.759	0.070
Firm Type	0.785	4.622	0.003
Political Connections x Firm Type	0.929	0.900	0.369
<u>Covariates</u>			
Business Risk	0.943	2.231	0.058
Fraud Risk	0.810	8.678	0.000
Error Risk	0.954	1.781	0.088
Perception (Q8a)	0.898	4.214	0.009
Perception (Q8d)	0.970	1.139	0.163

**Panel D: Univariate Results**

Source	DV	Type III Sum of Squares	Df	Mean Square	F	Significance (one-tailed)
Model	AFRelative	29.556	10	2.956	5.155	0.000
	AFAmount	1.112E10	10	1.112E9	6.064	0.000
<u>Independent Variable</u>						
Political Connections	AFRelative	0.487	2	0.244	0.425	0.328
	AFAmount	9.818E8	2	4.909E8	2.678	0.038
Firm Type	AFRelative	0.633	1	0.633	1.103	0.149
	AFAmount	2.027E9	1	2.027E9	11.059	0.001
Political Connections x Firm Type	AFRelative	1.033	2	0.516	0.900	0.206
	AFAmount	12482589.17	2	6241294.59	0.034	0.484
<u>Covariates</u>						
Business Risk	AFRelative	1.337	1	1.337	2.332	0.067
	AFAmount	7.148E8	1	7.148E8	3.900	0.026
Fraud Risk	AFRelative	7.017	1	7.017	12.239	0.001
	AFAmount	2.299E9	1	2.299E9	12.539	0.001
Error Risk	AFRelative	0.125	1	0.125	0.218	0.321
	AFAmount	4.072E8	1	4.072E8	2.221	0.070
Perception (Q8a)	AFRelative	0.332	1	0.332	0.579	0.225
	AFAmount	9.403E8	1	9.403E8	5.130	0.013
Perception (Q8d)	AFRelative	0.259	1	0.259	0.452	0.252
	AFAmount	4.228E8	1	4.228E8	2.306	0.067
Error	AFRelative	43.002	75	0.573		
	AFAmount	1.375E10	75	1.833E8		

**Panel E: Planned Comparisons**

<b>Planned Comparison Relating to the AFRelative between:</b>	<b>Mean Difference</b>	<b>Standard Error</b>	<b>Significance (one-tailed)</b>
Ruling Party Connections and No Political Connections	-0.173	0.324	0.298
Ruling Party Connections and Opposition Party Connections	0.100	0.212	0.320
Opposition Party Connections and No Political Connections	-0.273	0.307	0.189

<b>Planned Comparison Relating to the AFAmount between:</b>	<b>Mean Difference</b>	<b>Standard Error</b>	<b>Significance (one-tailed)</b>
Ruling Party Connections and No Political Connections	10046.840	5795.039	0.044
Ruling Party Connections and Opposition Party Connections	7989.651	3795.192	0.020
Opposition Party Connections and No Political Connections	2057.189	5487.855	0.355

Panel A and Panel B show the means and the adjusted means for the dependent variables. The adjusted means are the means from the MANCOVA conducted with Political Connections and Firm Type as the independent variables and five covariates (i.e., Business Risk, Fraud Risk, Error Risk, Perception (Q8a) and Perception (Q8d)). The adjusted means are the original means that have been adjusted for the effect of the control variables in the model. The mean difference reported in Panel E is the difference in the adjusted means. The dependent variables are the participant's audit fee decisions, which are measured by two variables: (1) AFRelative is the participant's assessment of the audit fee that the client would be charged in comparison to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Lower Audit Fee and 7 = Much Higher Audit Fee; (2) AFAmount is the participant's determination of the appropriate monetary audit fee based on audit fee figures for two typical clients (i.e., clients with high and low risk of material misstatement respectively) in the same industry comparable in size and complexity. Political Connections is a categorical variable with three categories, i.e., ruling party connections, opposition party connections and no connection. For the ruling party connections category, participants are informed that five out of seven board of directors, including the CEO, have a very close relationship with the country's top political leaders at the federal level who are currently in power. For the opposition party connections category, participants are informed that five out of seven board members, including the CEO, have a very close relationship with the country's top opposition leaders at the federal level. In the no connection category, the statement about the client's political connections is omitted from the materials provided to participants. Firm Type is a categorical variable that is coded as 1 for participants from a Big 4 firm and 0 for participants from a Non-Big 4 firm. Firm Type is a control variable that is used to control for any potential differences in the judgement of auditors from Big 4 and Non-Big 4 firms. Business Risk is the participant's assessment of business risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk. Fraud Risk is the participant's assessment of fraud risk on a 7-point scale where 1 = Very Low Risk and 7 = Very High Risk. Error Risk is the participant's assessment of error risk on a 7-point scale where 1 = Very Low Risk and 7 = Very High Risk. Perception (Q8a) is the participant's response to the question "In Malaysia, the strength of the relationship between parties to a contract always influence the determination of contract terms" anchored by 1= Strongly Disagree and 7 = Strongly Agree. Perception (Q8d) is the participant's response to the question "In Malaysia, the likelihood of the success of a tender for any government projects depends on the strength of connections to political leaders who are currently in power" anchored by 1= Strongly Disagree and 7 = Strongly Agree.

Panel A and Panel B of Table 5.10 show the means and the adjusted means for the dependent variables. The adjusted means are the means from the MANCOVA conducted with Political Connections and Firm Type as the independent variables and five covariates (i.e., Business Risk, Fraud Risk, Error Risk, Perception (Q8a) and Perception (Q8d)). The adjusted means are the original means that have been adjusted for the effect of the control variables in the model. The mean difference reported in Panel E of Table 5.10 is the difference in the adjusted means.

The MANCOVA results reported in Panel C of Table 5.10 show a significant main effect for a client's political connection on auditors' audit fee decisions ( $F = 1.759$ ,  $p = 0.070$ ). All of the covariates, except for Perception (Q8d), are significant. The results of univariate analyses reported in Panel D indicate that the effect of political connections on auditors' audit fee decision is significant for AFAmount ( $F = 2.678$ ,  $p = 0.038$ ). The effect of political connections on AFRelative is not significant ( $F = 0.425$ ,  $p = 0.328$ ).

H6a predicts that the average recommended audit fee for a client with ruling party connections will be higher than for a client with no political connections. Planned comparisons are conducted using a simple contrast and the results are presented in Panel E of Table 5.10. The results of planned comparisons between the ruling party connections and no political connections groups indicate that the average recommended monetary audit fee (AFAmount) for ruling party connections group is significantly higher than for the no political connections group (mean difference = 100046.840,  $p = 0.044$ ). However, the planned comparison between the ruling party connections and no political connections groups for AFRelative is not significant (mean difference = -0.173,  $p = 0.298$ ). Overall, the results of the planned comparisons show

that the average recommended audit fee for a client with ruling party connections is higher than for a client with no political connections, which supports H6a.

H6b predicts that the average recommended audit fee for a client with opposition party connections is higher than for a client with no political connections. The results of planned comparisons (Table 5.10, Panel E) between the opposition party connections and no political connections groups for both measures of recommended audit fee (AFRelative and AFAmount) indicate that there is no significant difference in the average recommended audit fee for a client with opposition party connections and no political connections. Therefore, H6b is not supported. The findings indicate that although the assessments of the risks of material misstatement and the assessments of the audit effort required for a client with opposition party connections are higher than for a client with no political connections, these have not been translated into a higher audit fee.

One possible explanation for the findings for H6b is that the auditors want to retain the client in anticipation that the political party or politicians the client is connected to could win Malaysia's next general election (at the federal level) that must be held before March 2013. Although the opposition party has never won the majority of the federal parliament seats in any previous general elections, the performance of the opposition in the last general elections shows that the party is in its best shape ever to win the coming general election. In the 2008 general election, the opposition party managed to deny the ruling party a 2/3 majority in the federal parliament for the first time in Malaysian history and captured five states (compared to only one state in the 2004 general election) (Mokhtar, 2008). The auditors may believe that the opposition party connected client will reap various favours and benefits through its

political connections should the opposition party manage to win the majority of the federal parliament seats in the coming general election and becomes the ruling government. The various favours and benefits will assist the client to expand its operations. This expansion implies that the client may require various consulting and advisory services from external parties, hence providing opportunities for the auditor to supply non-audit services to the client. The auditors may also benefit from a higher audit fee charged to the client as a result of its business expansion and the fact that the client is connected to the party that is in power.

H6c proposes that the average recommended audit fee for a client with ruling party connections will be higher than for a client with opposition party connections. The results of planned comparisons (Table 5.10, Panel E) between the ruling party connections and opposition party connections groups indicate that the average monetary audit fee, *AFAmount*, for a client with ruling party connections is significantly higher compared to a client with opposition party connections (mean difference = 7989.651,  $p = 0.020$ ). However, the difference between the ruling party connections and opposition party connections groups for *AFRelative* is not significant (mean difference = 0.100,  $p = 0.320$ ). Overall, the results of the planned comparisons show that the average audit fee for a client with ruling party connections is higher than for a client with opposition party connections, which supports H6c.



### 5.10 Additional Analyses Using Structural Equation Modelling (SEM)

Additional analyses are conducted using structural equation modelling (AMOS 18). Based on the theoretical foundation discussed previously, a structural equation models that fits the data set for this study are developed. Recall that the independent variable, political connections, is manipulated at three levels: (1) ruling party connections; (2) opposition party connections; and (3) no political connections. The hypothesised models are validated to two of the groups each time: (1) ruling party connections and no political connections groups; (2) opposition party connections and no political connections groups; and (3) ruling party connections and opposition party connections groups.

Evidence of proper model fit in structural equation modelling research is provided by a number of fit indices. However, there is no strict requirement as to which fit indices should be reported in a structural equation modelling study (Hair, Black, Babin and Anderson, 2010). A number of commonly used goodness of fit indices such as the overall chi-square value, the root mean square error of approximation (RMSEA) and adjusted goodness of fit index (AGFI) are known to be sensitive to sample size (e.g., Byrne, 2010; Smith and Langfield-Smith, 2004; Hu and Bentler, 1999; Fan, Thompson and Wang, 1999). Considering the sample size in this study, a combination of three other fit indices are used to evaluate the overall model fit: (1) Goodness-of-Fit Index (GFI); (2) Normed Fit Index (NFI); and (3) Comparative Fit Index (CFI). In comparison to GFI and NFI, CFI is a more robust index, which takes sample size into consideration (Bentler, 1990). According to Byrne (2010), values equal to or greater than 0.90 are desirable for each of GFI, NFI and CFI.

The results of the structural equation modelling are discussed in the following subsections. Subsection 5.10.1 discusses the results for the ruling party connections and no political connections groups and Subsection 5.10.2 discusses the results for the opposition party connections and no political connections groups. Subsection 5.10.3 discusses the results for ruling party connections and opposition party connections groups.

### 5.10.1 Ruling Party Connections and No Political Connections Groups

The results for the ruling party connections and no political connections groups are presented in Exhibit 5.1. There are five dependent variables in the model: (1) Business Risk; (2) Fraud Risk; (3) Error Risk; (4) Audit Effort; and (5) Audit Fee. The first dependent variable, Business Risk, is measured by the participant's assessments of business risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk. The second dependent variable, Fraud Risk, is measured by the participant's assessment of fraud risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk. The third dependent variable, Error Risk, is measured by the participant's assessment of error risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk. The fourth dependent variable, Audit Effort, is measured by the participant's assessment of the audit effort they would allocate for the audit of the client compared to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Lower Effort and 7 = Much higher effort. The fifth dependent variable, Audit Fee, is measured by is participant's assessment of the audit fee that the client would be charged in comparison to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Lower Audit Fee and 7 = Much Higher Audit Fee. Although the effect of firm type on the dependent variables is not the main focus of this study, firm type is included as another independent variable in the model to control for any potential effect of firm type on the dependent variables.

The model appears to provide a good fit with the dataset (GFI = 0.917, NFI = 0.877, CFI = 0.880). In light of the theoretical foundation discussed previously and the

values of goodness of fit indices, this model provides the best fit to the data.<sup>23</sup> Hence, it is used to analyse the hypotheses in this thesis.

The results indicate that political connections do not affect the average assessment of a client's business risk, which implies that there is no significant difference in the average assessments of business risk for clients with ruling party connections and those with no political connections. Therefore, H2a is not supported. Political connections, however, have a significant effect on the assessment of a client's fraud risk (path coefficient = 0.399,  $p = 0.048$ ) and error risk (path coefficient = 0.386,  $p = 0.089$ ). These results mean that the average assessment of a client's fraud risk is higher for a client with ruling party connections than for a client with no political connections, which supports H3a. Similarly, the average assessment of a client's error risk is higher for a client with ruling party connections than for a client with no political connections, which supports H4a.

Contrary to the predictions in H5a, the results in Exhibit 5.1, Panel A, indicate that the direct effect of political connections on the assessment of required audit effort is not significant (path coefficient = 0.072,  $p = 0.350$ ). Instead, the results show that political connections affect the assessment of required audit effort indirectly through the assessment of fraud risk (path coefficient = 0.370,  $p = 0.000$ ). The indirect effect of political connections on audit effort via fraud risk assessment suggests that the higher average assessment of fraud risk for a client with ruling party connections

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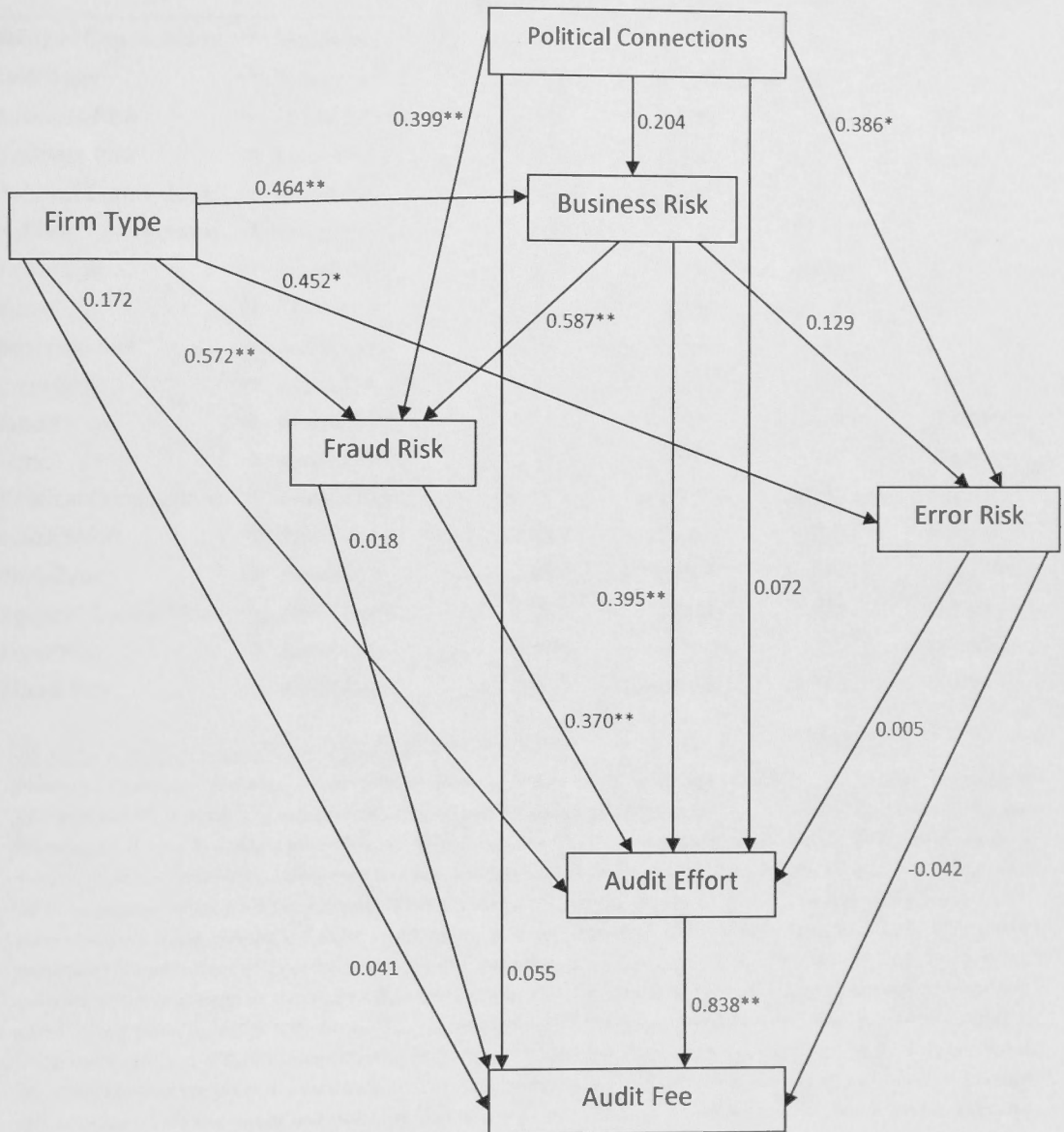
<sup>23</sup> Other measures of the dependent variables have been used in developing initial models. However, in light of the theoretical foundation of this study and the value of goodness of fit indices of the initial models, these measures are not included in the final model.

than for a client with no political connections leads to a higher average assessment of audit effort for a client with ruling party connections than for a client with no political connections.

The path coefficient from political connections to the recommended audit fee suggests that political connections do not have a significant effect on auditors' average recommended audit fee (path coefficient = 0.055,  $p = 0.338$ ), which does not support H6a. However, the results reported in Exhibit 5.1, Panel A indicate that political connections affect auditors' recommended audit fee indirectly via the assessment of fraud risk and the assessment of audit effort. The results suggest that a higher average assessment of fraud risk for a client with ruling party connections than for a client with no political connections leads to a higher assessment of audit effort for a client with ruling party connections, which, in turn, leads to a higher average recommended audit fee.

**Exhibit 5.1 Ruling Party Connections and No Political Connections Groups**

**Panel A: Structural Equation Model with Path Coefficients**



\*\*Significant at  $p < 0.05$ ; \*Significant at  $p < 0.10$



**Panel B: Structural Equation Modelling Results**

Linkage	Path Coefficient	Standard Error	Critical Ratio	Significance (one-tailed)
Political Connections → Business Risk	0.204	0.185	1.105	0.135
Firm Type → Business Risk	0.464	0.183	2.533	0.006
Business Risk → Fraud Risk	0.587	0.173	3.398	0.000
Business Risk → Error Risk	0.129	0.206	0.625	0.266
Political Connections → Fraud Risk	0.399	0.239	1.665	0.048
Political Connections → Error Risk	0.386	0.286	1.351	0.089
Firm Type → Fraud Risk	0.572	0.248	2.303	0.011
Firm Type → Error Risk	0.452	0.296	1.527	0.064
Business Risk → Audit Effort	0.395	0.143	2.761	0.003
Error Risk → Audit Effort	0.005	0.085	0.056	0.478
Fraud Risk → Audit Effort	0.370	0.101	3.656	0.000
Firm Type → Audit Effort	0.172	0.199	0.862	0.195
Political Connections → Audit Effort	0.072	0.187	0.385	0.350
Audit Effort → Audit Fee	0.838	0.089	9.390	0.000
Firm Type → Audit Fee	0.041	0.141	0.289	0.387
Political Connections → Audit Fee	0.055	0.132	0.418	0.338
Error Risk → Audit Fee	-0.042	0.060	-0.707	0.240
Fraud Risk → Audit Fee	0.018	0.078	0.230	0.409

Model fit: GFI = 0.917; NFI = 0.877; CFI = 0.880

Political Connections is a categorical variable that is coded as 1 for ruling party connections and 0 for no political connections. Firm Type is a categorical variable that is coded as 1 for participants from a Big 4 firm and 0 for participants from a Non-Big 4 firm. Business Risk is measured by the participant's assessments of business risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk. Firm Type is a categorical variable that is coded as 1 for participants from a Big 4 firm and 0 for participants from a Non-Big 4 firm. Fraud Risk is the participant's assessment of fraud risk on a 7-point scale where 1 = Very Low Risk and 7 = Very High Risk. Error Risk is the participant's assessment of error risk on a 7-point scale where 1 = Very Low Risk and 7 = Very High Risk. Effort is the participant's assessment of the audit effort they would allocate for the audit of the client compared to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Lower Effort and 7 = Much higher effort. Audit Fee is the participant's assessment of the audit fee that the client would be charged in comparison to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Lower Audit Fee and 7 = Much Higher Audit Fee.

### **5.10.2 Opposition Party Connections and No Political Connections Groups**

The results for the opposition party connections and no political connections groups are presented in Exhibit 5.2. There are five dependent variables in the model: (1) Business Risk; (2) Fraud Risk; (3) Error Risk; (4) Audit Effort; and (5) Audit Fee. The first dependent variable, Business Risk, is measured by the participant's assessments of business risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk. The second dependent variable, Fraud Risk, is measured by the participant's assessment of fraud risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk. The third dependent variable, Error Risk, is measured by the participant's assessment of error risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk. The fourth dependent variable, Audit Effort, is measured by the participant's assessment of the audit effort they would allocate for the audit of the client compared to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Lower Effort and 7 = Much higher effort. The fifth dependent variable, Audit Fee, is measured by is participant's assessment of the audit fee that the client would be charged in comparison to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Lower Audit Fee and 7 = Much Higher Audit Fee. Although the effect of firm type on the dependent variables is not the main focus of this study, firm type is included as another independent variable in the model to control for any potential effect of firm type on the dependent variables.

The model appears to provide a good fit with the dataset (GFI = 0.931, NFI = 0.910, CFI = 0.918). In light of the theoretical foundation discussed previously and the values of goodness of fit indices, this model provides the best fit to the data.<sup>24</sup> Hence, it is used to analyse the hypotheses in this thesis.

The results indicate that political connections do not affect the average assessment of a client's business risk, which implies that there is no significant difference in the average assessments of business risk for clients with opposition party connections and those with no political connections. Therefore, H2b is not supported. Political connections, however, have a significant effect on the assessment of a client's fraud risk (path coefficient = 0.429,  $p = 0.043$ ) and error risk (path coefficient = 0.501,  $p = 0.030$ ). These results indicate that the average assessment of a client's fraud risk is higher for a client with opposition party connections than for a client with no political connections, which supports H3b. Similarly, the average assessment of a client's error risk is higher for a client with opposition party connections than for a client with no political connections, which supports H4b.

Contrary to the predictions in H5b, the results shown in Exhibit 5.2, Panel A indicate that the direct effect of political connections on the average assessment of required audit effort is not significant (path coefficient = 0.051,  $p = 0.390$ ). Instead, the results indicate that political connections affect the assessment of required audit effort indirectly through the assessment of fraud risk (path coefficient = 0.477,  $p = 0.000$ ) and

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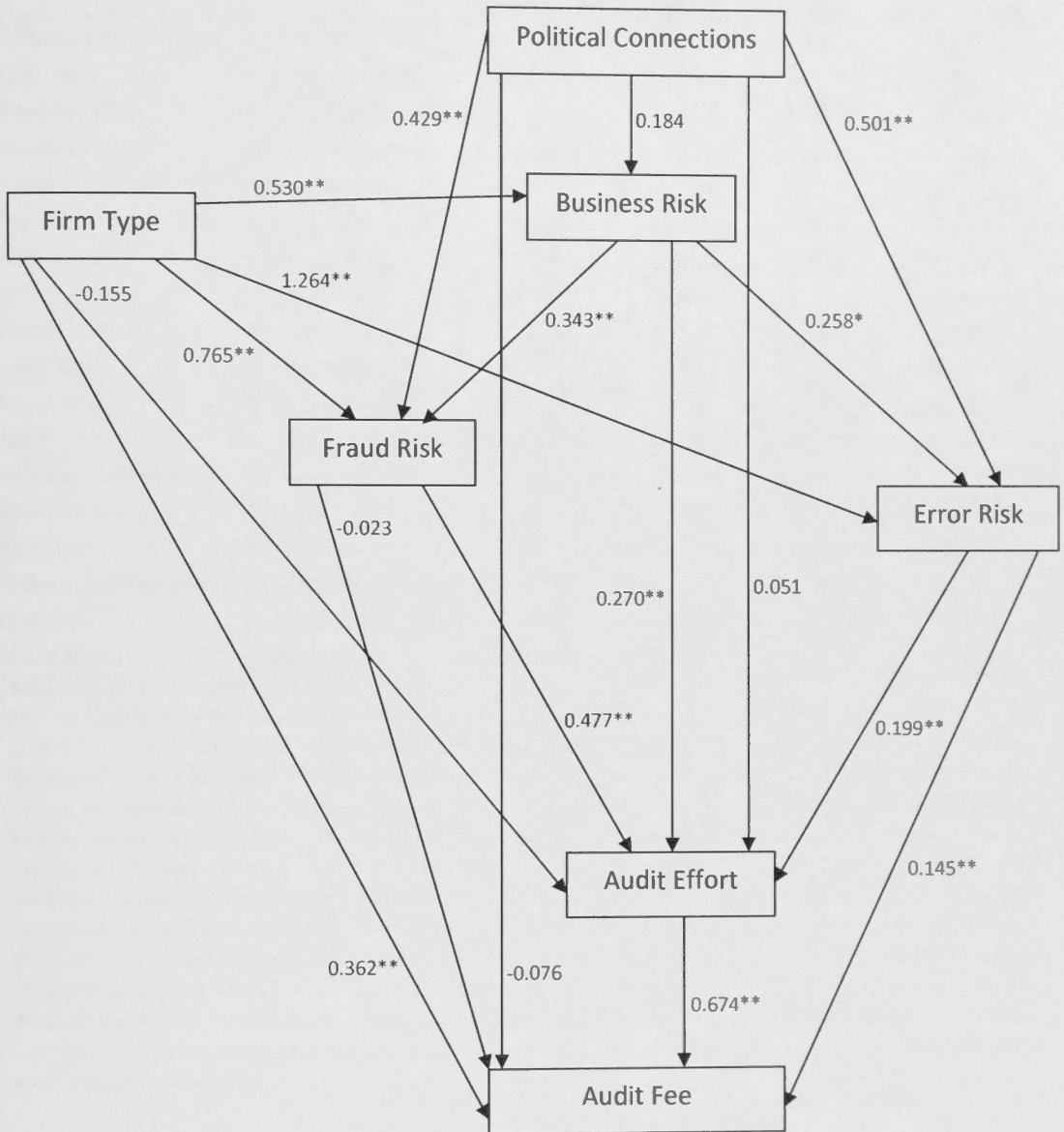
<sup>24</sup> Other measures of the dependent variables have been used in developing initial models. However, in light of the theoretical foundation of this study and the values of goodness of fit indices of the initial models, these measures are not included in the final model.

the assessment of error risk (path coefficient = 0.199,  $p = 0.015$ ). The indirect effect of political connections on required audit effort via fraud risk assessment and error risk assessment suggests that the higher average assessment of fraud risk and error risk for a client with opposition party connections than for a client with no political connections leads to a higher average assessment of recommended audit effort for a client with opposition party connections than for a client with no political connections.

The path coefficient from political connections to recommended audit fee indicates that political connections do not have a significant effect on auditors' recommended audit fee (path coefficient = -0.076,  $p = 0.318$ ), which does not support H6b. However, Exhibit 5.2, Panel A indicates that political connections affect auditors' recommended audit fee indirectly via the assessment of fraud risk and the assessment of error risk, which, in turn, affects the assessment of audit effort. The results indicate that a higher average assessment of fraud risk and error risk for a client with opposition party connections than for a client with no political connections leads to a higher assessment of required audit effort for a client with opposition party connections. This, in turn, leads to a higher average recommended audit fee for a client with opposition party connections than for a client with no political connections. In addition, the results shown in Exhibit 5.2, Panel A also indicate that the effect of political connections on the assessment of error risk, in turn, affects auditors' recommended audit fee (path coefficient = 0.145,  $p = 0.040$ )

**Exhibit 5.2 Opposition Party Connections and No Political Connections Groups**

**Panel A: Structural Equation Model with Path Coefficients**



\*\*Significant at  $p < 0.05$ ; \*Significant at  $p < 0.10$

**Panel B: Structural Equation Modelling Results**

Linkage		Path Coefficient	Standard Error	Critical Ratio	Significance (one-tailed)
Political Connections	→ Business Risk	0.184	0.194	0.950	0.171
Firm Type	→ Business Risk	0.530	0.214	2.475	0.007
Business Risk	→ Fraud Risk	0.343	0.180	1.903	0.029
Business Risk	→ Error Risk	0.258	0.192	1.347	0.089
Political Connections	→ Fraud Risk	0.429	0.249	1.719	0.043
Political Connections	→ Error Risk	0.501	0.265	1.888	0.030
Firm Type	→ Fraud Risk	0.765	0.289	2.648	0.004
Firm Type	→ Error Risk	1.264	0.307	4.112	0.000
Business Risk	→ Audit Effort	0.270	0.130	2.081	0.019
Error Risk	→ Audit Effort	0.199	0.091	2.184	0.015
Fraud Risk	→ Audit Effort	0.477	0.097	4.932	0.000
Firm Type	→ Audit Effort	-0.155	0.240	-0.643	0.260
Political Connections	→ Audit Effort	0.051	0.182	0.280	0.390
Audit Effort	→ Audit Fee	0.674	0.119	5.677	0.000
Firm Type	→ Audit Fee	0.362	0.210	1.726	0.042
Political Connections	→ Audit Fee	-0.076	0.159	-0.475	0.318
Error Risk	→ Audit Fee	0.145	0.083	1.751	0.040
Fraud Risk	→ Audit Fee	-0.023	0.103	-0.226	0.412

Model fit: GFI = 0.931; NFI = 0.910; CFI = 0.918

Political Connections is a categorical variable that is coded as 1 for opposition party connections and 0 for no political connections. Firm Type is a categorical variable that is coded as 1 for participants from a Big 4 firm and 0 for participants from a Non-Big 4 firm. Business Risk is measured by the participant's assessments of business risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk. Firm Type is a categorical variable that is coded as 1 for participants from a Big 4 firm and 0 for participants from a Non-Big 4 firm. Fraud Risk is the participant's assessment of fraud risk on a 7-point scale where 1 = Very Low Risk and 7 = Very High Risk. Error Risk is the participant's assessment of error risk on a 7-point scale where 1 = Very Low Risk and 7 = Very High Risk. Effort is the participant's assessment of the audit effort they would allocate for the audit of the client compared to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Lower Effort and 7 = Much higher effort. Audit Fee is the participant's assessment of the audit fee that the client would be charged in comparison to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Lower Audit Fee and 7 = Much Higher Audit Fee.



### 5.10.3 Ruling Party Connections and Opposition Party Connections Groups

The results for the ruling party connections and opposition party connections groups are presented in Exhibit 5.3. There are five dependent variables in the model: (1) Business Risk; (2) Fraud Risk; (3) Error Risk; (4) Audit Effort; and (5) Audit Fee. The first dependent variable, Business Risk, is measured by the participant's assessments of business risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk. The second dependent variable, Fraud Risk, is measured by the participant's assessment of fraud risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk. The third dependent variable, Error Risk, is measured by the participant's assessment of error risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk. The fourth dependent variable, Audit Effort, is measured by the participant's assessment of the audit effort they would allocate for the audit of the client compared to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Lower Effort and 7 = Much higher effort. The fifth dependent variable, Audit Fee, is measured by is participant's assessment of the audit fee that the client would be charged in comparison to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Lower Audit Fee and 7 = Much Higher Audit Fee. Although the effect of firm type on the dependent variables is not the main focus of this study, firm type is included as another independent variable in the model to control for any potential effect of firm type on the dependent variables.

The model appears to provide a good fit with the dataset (GFI = 0.937, NFI = 0.885, CFI = 0.890). In light of the theoretical foundation discussed previously and the values of goodness of fit indices, this model provides the best fit to the data.<sup>25</sup> Hence, it is used to analyse the hypotheses in this thesis.

The results indicate that political connections do not affect the average assessment of a client's business risk, which also implies that there is no significant difference in the average assessments of business risk for clients with ruling party connections and those with opposition party connections. Therefore, H2c is not supported. Political connections also do not affect the assessment of a client's fraud risk (path coefficient = -0.039,  $p = 0.422$ ) and error risk (path coefficient = -0.088,  $p = 0.361$ ). These results also mean that there is no difference in the average assessments of fraud risk for clients with ruling party connections and those with opposition party connections, which supports H3c. In addition, the results also mean that there is no difference in the average assessments of error risk for clients with ruling party connections and those with opposition party connections, which does not support H4c.

The results shown in Exhibit 5.3, Panel A indicate that the direct effect of political connections on the average assessment of required audit effort is not significant (path coefficient = -0.161,  $p = 0.184$ ), which does not support H5c. However, the path coefficient from political connections to audit fee indicates that the direct effect of political connections on auditors' recommendation of the average audit fee is

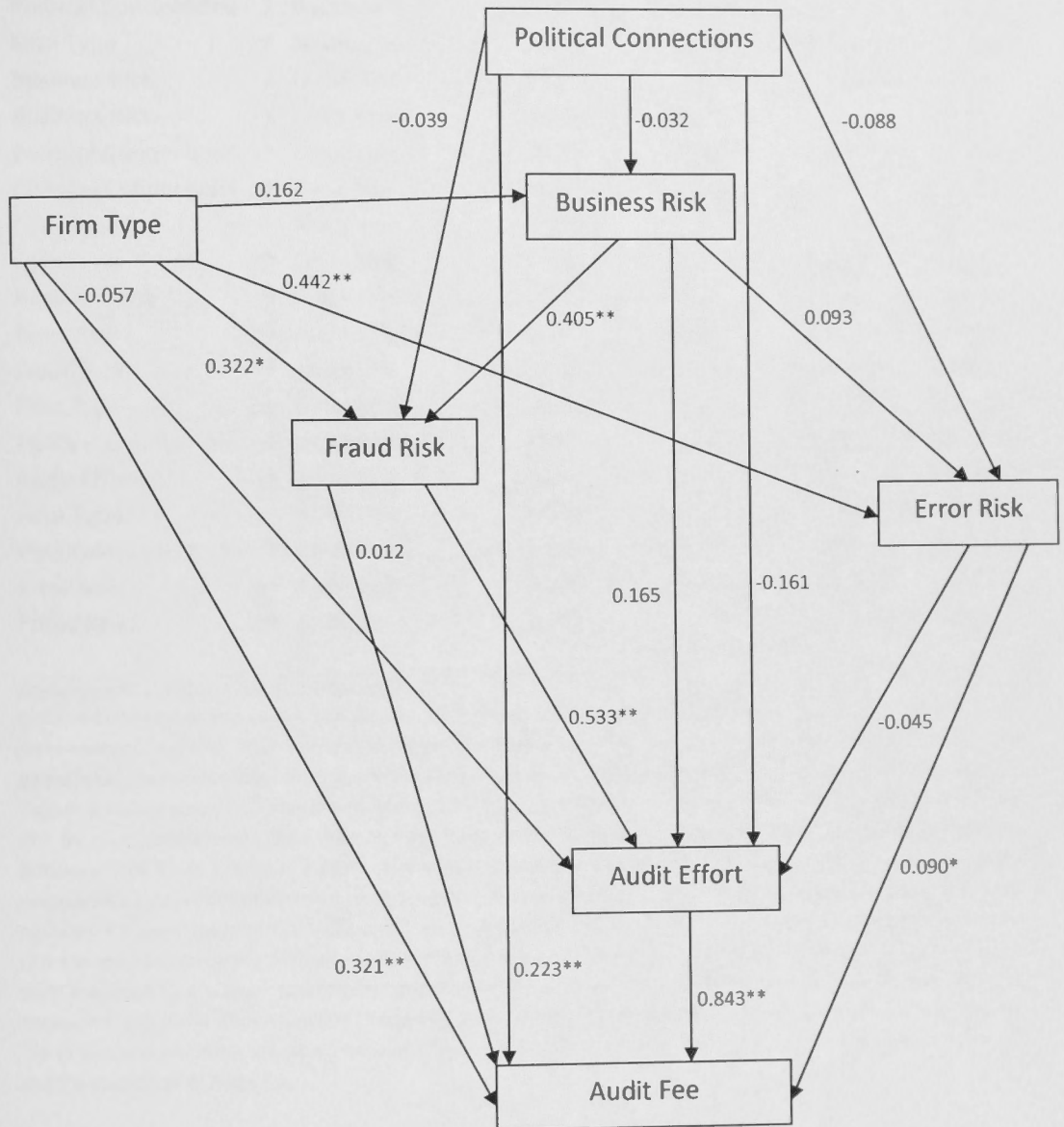
---

<sup>25</sup> Other measures of the dependent variables have been used in developing initial models. However, in light of the theoretical foundation of this study and the value of goodness of fit indices of the initial models, these measures are not included in the final model.

significant (path coefficient = 0.223  $p = 0.035$ ). The results indicate that the average recommended audit fee for a client with ruling party connections is significantly higher than for a client with opposition party connections.

**Exhibit 5.3 Ruling Party Connections and Opposition Party Connections Groups**

**Panel A: Structural Equation Model with Path Coefficients**



\*\*Significant at  $p < 0.05$ ; \*Significant at  $p < 0.10$

**Panel B: Structural Equation Modelling Results**

Linkage	Path	Standard	Critical	Significance
	Coefficient	Error	Ratio	(one-tailed)
Political Connections → Business Risk	-0.032	0.180	-0.179	0.429
Firm Type → Business Risk	0.162	0.183	0.883	0.189
Business Risk → Fraud Risk	0.405	0.137	2.955	0.002
Business Risk → Error Risk	0.093	0.172	0.542	0.294
Political Connections → Fraud Risk	-0.039	0.198	-0.196	0.422
Political Connections → Error Risk	-0.088	0.249	-0.356	0.361
Firm Type → Fraud Risk	0.322	0.202	1.591	0.056
Firm Type → Error Risk	0.442	0.254	1.736	0.042
Business Risk → Audit Effort	0.165	0.132	1.244	0.107
Error Risk → Audit Effort	-0.045	0.090	-0.501	0.309
Fraud Risk → Audit Effort	0.533	0.113	4.717	0.000
Firm Type → Audit Effort	-0.057	0.191	-0.298	0.383
Political Connections → Audit Effort	-0.161	0.179	-0.902	0.184
Audit Effort → Audit Fee	0.843	0.085	9.961	0.000
Firm Type → Audit Fee	0.321	0.131	2.456	0.007
Political Connections → Audit Fee	0.223	0.123	1.812	0.035
Error Risk → Audit Fee	0.090	0.061	1.458	0.073
Fraud Risk → Audit Fee	0.012	0.088	0.138	0.445

Model fit: GFI = 0.937; NFI = 0.885; CFI = 0.890

Political Connections is a categorical variable that is coded as 1 for ruling party connections and 0 for opposition party connections. Firm Type is a categorical variable that is coded as 1 for participants from a Big 4 firm and 0 for participants from a Non-Big 4 firm. Business Risk is measured by the participant's assessments of business risk on a 7-point scale anchored by 1 = Very Low Risk and 7 = Very High Risk. Firm Type is a categorical variable that is coded as 1 for participants from a Big 4 firm and 0 for participants from a Non-Big 4 firm. Fraud Risk is the participant's assessment of fraud risk on a 7-point scale where 1 = Very Low Risk and 7 = Very High Risk. Error Risk is the participant's assessment of error risk on a 7-point scale where 1 = Very Low Risk and 7 = Very High Risk. Effort is the participant's assessment of the audit effort they would allocate for the audit of the client compared to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Lower Effort and 7 = Much higher effort. Audit Fee is the participant's assessment of the audit fee that the client would be charged in comparison to another client in the same industry with an average risk of material misstatement and that is of similar size on a 7-point scale anchored by 1 = Much Lower Audit Fee and 7 = Much Higher Audit Fee.

### 5.11 Summary

In general, the results support all of the hypotheses, except H6b. The results support the prediction of H1 that that auditors in the ruling party (opposition party) connections group are more likely to identify political connections as a factor that decreases (increases) a client's business risk compared to auditors in the opposition party (ruling party) connections group.

The results for H2a support the hypothesis that the average assessment of business risk is higher for a client with ruling party connections compared to a client with no political connections. The findings for H2b support its prediction that the average assessment of business risk is higher for a client with opposition party connections compared to a client with no political connections. As predicted in H2c, the results support the hypothesis that there is no difference in the average assessments of business risk for clients with ruling party connections and opposition party connections.

It is expected that auditors' assessment of business risk will, in turn, affect their assessments of risks of material misstatement due to fraud and error. The findings in this study indicate that a client's political connections affect auditors' assessment of fraud risk. The results show that the average assessment of a client's fraud risk is higher for a client with ruling party connections than for a client with no political connections, hence providing support for H3a. The results also support H3b that the average assessment of a client's fraud risk is higher for a client with opposition party connections than for a client with no political connections. The prediction in H3c that there is no difference in the average assessments of fraud risk for a client with ruling party connections and opposition party connections is also supported.



An effect for political connections on auditors' assessments of error risk is also observed. The results support H4a that the average assessment of error risk is higher for a client with ruling party connections than for a client with no political connections. H4b prediction that the average assessment of a client's error risk is higher for a client with opposition party connections than for a client with no political connections is also supported. The results also provide evidence that the average assessment of a client's error risk is higher for a client with ruling party connections than for a client with opposition party connections, which supports H4c.

The results indicate that the effects of a client's political connections on auditors' assessments of the risks of material misstatement due to fraud and error affect their assessments of audit effort required and their recommended audit fee decisions. The findings show that auditors' average assessment of required audit effort is higher for a client with ruling party connections compared to a client with no political connections, thereby supporting H5a. Consistent with this, the results demonstrate that the recommended audit fee for a client with ruling party connections is higher than for a client with no political connections, hence providing support for H6a.

The findings for H5b support the hypothesis that the average assessment of audit effort required are higher for a client with opposition party connections than for a client with no political connections. However, contrary to expectations, the results for H6b indicate there is no significant difference in the average recommended audit fee for a client with opposition party connections and one with no political connections. The results for H5c provide weak support for the hypothesis that the audit effort required for a client with ruling party connections is higher than for a client

with opposition party connections. Consistent with expectations, the results for H6c indicate that the average recommended audit fee for a client with ruling party connections is higher than for a client with opposition party connections.

Overall, the results of the main analyses in this chapter provide evidence that auditors consider political connections as a factor that affects a client's business risk. The results also provide evidence on the effect of a client's political connections on auditors' assessments of fraud risk and error risk, their assessments of audit effort required and their audit fee decisions. Additional analyses using structural equation modelling provide mixed results. However, a limitation of the structural equation modelling approach compared to using MANOVA is that structural equation modelling only considers one measure of each of the variables concurrently, whereas MANOVA considers the effects of multiple measures of the dependent variables concurrently and the relationships between the multiple measures of the same construct. The next chapter provides a summary and conclusions for this thesis.

# CHAPTER 6

## Summary and Conclusions

---

### 6.1 Introduction

This chapter first restates the research objectives, hypotheses and research findings. This is followed by Section 6.3, which discusses the potential limitations of this research. The final section of this chapter suggests areas for future research.

### 6.2 Summary of Research Objective, Hypotheses and Research Findings

Recent archival studies provide evidence that fraudulent firms that are politically connected to those in power have a higher probability of avoiding fraud detection by regulators (Yu and Yu, forthcoming) and are less likely to be involved in SEC enforcement actions (Correia, 2010). Despite the findings in prior studies about the various effects of political connections on firms, no prior research examines the effect of political connections on the judgments of auditors, who are responsible for providing reasonable assurance that the firm's financial statements are free of material misstatement. The objective of this thesis is to examine the effect of political connections on auditors' judgments using an experimental approach. Specifically, this thesis examines whether auditors perceive political connections as a factor that increases or decreases a client's business risk. It also investigates whether a client's political connections affect auditors' assessments of business risk, fraud risk and error risk. This thesis extends the archival work of Gul (2006) by examining the effects of client's political connections on auditors' decisions of the audit effort required and their recommended audit fee.

In this thesis, political connections are manipulated at three levels: ruling party connections; opposition party connections; and no political connections. Auditors in the ruling party connections group received information indicating five out of seven board members, including the CEO, have a very close relationship with the country's top political leaders at the federal level who are currently in power. For auditors in the opposition party connections group, the case materials include information that five out of seven board members, including the CEO, have a very close relationship with the country's top opposition leaders at the federal level. Auditors in the no connections group, on the other hand, are not provided with the information about the client's political connections.

As prior studies find evidence that ruling party connected firms are in a position to receive various benefits and favours from politicians and the government in power, and that opposition party connected firms are prone to negative treatment from them, H1 proposes that auditors in the ruling party (opposition party) connections group are more likely to identify political connections as a factor that decreases (increases) a client's business risk compared to auditors in the opposition party (ruling party) connections group. The findings for H1 support the prediction.

Although the existence of political connections is considered a factor that decreases a client's business risk for a client with ruling party connections, it does not necessarily lead to a lower assessment of overall business risk for a client with ruling party connections as there are various costs and drawbacks associated with ruling party connections. It is argued that the costs and drawbacks associated with ruling party connections may offset the benefits and favours that can be accessed through such connections, hence leading to higher overall business risk for firms with ruling

party connections. Although firms with no political connections are not in a position to receive favours and benefits from politicians and the government in power, these firms are not subject to the costs and drawbacks that may be associated with ruling party connections. Hence, H2a predicts that the average assessment of a client's business risk is higher for a client with ruling party connections than for a client with no political connections. The findings for H2a support the prediction.

For opposition party connected firms, apart from not being in a position to receive favours and benefits and being prone to negative treatment from the politicians or government currently in power, such firms are also associated with some of the costs and drawbacks linked to ruling party connections. In contrast to firms with opposition party connections, firms with no political connections are not subject to negative treatment and retaliation from politicians or the government in power, hence such firms have a lower business risk than firms with opposition party connections. The findings for H2b support the hypothesis that the average assessment of a client's business risk is higher for a client with opposition party connections compared to that for a client with no political connections. Given that ruling party connected firms and opposition party connected firms are associated with high business risk, H2c predicts that there is no difference in the average assessments of business risk for auditors in the ruling party connections and opposition party connections groups. The findings support this prediction.

Consistent with prior research, it is argued that auditors' assessment of business risk influence their subsequent assessments of the risks of material misstatement that can arise from fraud or error. H3a predicts that the average assessment of a client's fraud risk is higher for a client with ruling party connections

compared to that for a client with no political connections. Firms with ruling party connections are expected to have a higher risk of fraud for several reasons. First, the inherent inefficiency associated with ruling party connected firms implies that these firms may not be able to utilise the benefits and favours received from their political connections to the fullest possible extent. During difficult times, such as during an economic crisis, when innovation, productivity and efficiency are critical, the benefits and favours received by ruling party connected firms do not necessarily lead to a better performance due to its inherent inefficiency. This could lead to higher risks of material misstatement due to fraud as management is under pressure to meet shareholders' expectations, particularly when substantial resources have been allocated to rent seeking activities.

Second, ruling party connected firms may have received favours and benefits through various means including via related party transactions. This could provide opportunity for fraudulent financial reporting, hence increasing the risks of material misstatement due to fraud. Third, the complex nature of some rent seeking activities and the less transparent nature of their disclosure in the financial statements of politically connected firms (Leuz and Oberholzer-Gee, 2006) may increase the opportunity for management to commit financial statement fraud. This, in turn, leads to higher risks of material misstatement due to fraud for ruling party connected firm. The findings for H3a support the prediction.

The fact that opposition party connected firms are not likely to receive favours and benefits from politicians and the government currently in power and are prone to negative treatment from them could lead to a higher risk of fraud for opposition party connected firms. Management of opposition party firms are under pressure to



meet shareholders' expectations, particularly when substantial resources have been allocated to rent seeking activities without a corresponding increase in the firms' value. In addition, the complex nature of some rent seeking activities and the less transparent nature of their disclosure in the financial statements of politically connected firms (Leuz and Oberholzer-Gee, 2006) may increase the opportunity for management to commit financial statement fraud. This, in turn, leads to higher risks of material misstatement due to fraud for opposition party connected firm. The findings of this study show that the prediction in H3b that the average assessment of a client's fraud risk is higher for a client with opposition party connections than for a client with no political connections is supported. Given that firms with ruling party connections and firms with opposition party connections are associated with higher fraud risk, H3c predicts that there is no difference in the average assessments of fraud risk for clients with ruling party connections and opposition party connections. The results support H3c.

With respect to error risk, H4a predicts that the average assessment of a client's error risk is higher for a client with ruling party connections compared to that for a client with no political connections. A higher assessment of error risk for a client with ruling party connections is attributable to a number of reasons. First, unlike in the US where political contributions are regulated and must be disclosed explicitly in the financial statements, there is no such requirement in Malaysia. Without such a requirement, the resources spent for various rent seeking activities are recorded at management's discretion based on the nature of the activities. The complex nature of some rent seeking activities, especially those that are dubious in nature, may lead to incorrect recording or incorrect classification of such transactions, hence increasing the

risk of error for ruling party connected clients. Second, the fact that ruling party connected firms may receive benefits and favours through various related party transactions increases the risk that some of the related party transactions are not disclosed or disclosed incorrectly. The results support H4a.

As firms with opposition party connections are also involved in rent seeking activities, H4b proposes that the average assessment of error risk is higher for a client with opposition party connections compared to that for a client with no political connections. The results support H4b. Although opposition party connected firms are also involved in rent seeking activities, their involvement is at a lesser extent compared to ruling party connected firms. In addition, opposition party connected firms are not likely to receive benefits and favours from their political connections. These imply that the likelihood of error in relation to the recoding of the rent seeking activities and disclosure of related party transactions is lower for opposition party connected firms compared to ruling party connected firms. Hence, H4c predicts that the average assessment of a client's error risk is higher for a client with ruling party connections compared to that for a client with opposition party connections. The results provide weak support for H4c.

Higher risks of material misstatement implies that auditors need to increase their audit effort in order to gather the required evidence and provide an appropriate audit opinion, which, in turn, should result in a higher audit fee being charged to the client. H5a, which predicts that the average assessment of required audit effort is higher for a client with ruling party connections compared to that for a client with no political connections is supported. Consistent with this, auditors recommended a

higher audit fee for a client with ruling party connections compared to the fee recommended for a client with no political connections, which supports H6a.

H5b predicts that the average assessment of audit effort required is higher for a client with opposition party connections than for a client with no political connections. The results support H5b. However, contrary to expectations, the results for H6b indicate that there is no significant difference in the average recommended audit fee for a client with opposition party connections and a client with no political connections. Therefore, H6b is not supported. The findings indicate that although the average assessments of the risks of material misstatement and audit effort required for a client with opposition party connections are higher than for a client with no political connections, these have not been translated into a higher recommended audit fee. One possible explanation for this is that the auditors want to retain the client in anticipation that the political party or politicians the client is connected to could win Malaysia's next general election (at the federal level). If the opposition wins the next general election, opposition party connected firms will become ruling party connected and be in a position to receive various favours and benefits that will assist the client to expand its operations. In expanding its business, the client may require consulting and advisory services from external parties, thus providing opportunities for the auditor to supply non-audit services to the client. The auditors may also benefit from a higher audit fee charged to the client as the results of its business expansion and the fact that the client will be connected to the party in power.

Furthermore, the results support H5c, which predicts that the audit effort required for a client with ruling party connections is higher than that for a client with opposition party connections. The higher audit effort required for a ruling party

connected client leads to a higher audit fee being charged to the ruling party  
connected client compared to the opposition party connected client, thus supporting  
H6c.

### 6.3 Limitations

There are a number of limitations associated with this study. First, there are uneven numbers of participants in the cells, with 35 participants in the ruling party connections group, 31 in the opposition party connections group and 21 in the no political connections group. Participants were randomly assigned to each of the groups before being provided with the research instrument. While every effort was taken to ensure that participants were allocated equally to each group, a number of potential participants who initially agreed to participate in the research did not complete and return the experimental material provided to them. Also, a few responses had to be excluded from the analysis as the responses were either substantially incomplete or they had been completed by junior auditors.

Second, the experiment was not conducted under a controlled setting. Instead, participants completed the questionnaire at their own convenience. Trotman (1996) lists a number of potential issues associated with an experiment conducted in a non-controlled setting. One of the main concerns in this study is that participants are not working independently of each other. However, the potential interaction between participants should be partially offset by providing instructions to the participants that they should work independently of anyone else. The effects of other extraneous variables such as the surroundings when the participants completed the instrument should be minimal given that the participants are randomly allocated to each treatment group.

Third, the fact that the case materials used in the study are developed based on scenarios in an emerging economy, Malaysia and participants in the study are Malaysian auditors limit the generalisability of the findings from this study. Prior

research provides evidence that the influence of political connections on various aspects of business is a worldwide phenomenon existing in less developed, emerging and developed economies (Faccio, 2006). The scenario in the case materials is developed based on reference to the prior literature. Hence, generalisation of the findings in this study is still possible albeit to a limited extent due to the differences in various aspects such as economies, legal systems, politics, social and cultural settings between countries.

Fourth, the scenario in the case materials provided to the participants in this research is not exactly the same as the scenario examined by Gul (2006), albeit it is similar. Gul (2006) examines the effects of political connections on the audit fees of politically connected and non-politically connected firms during the onset of the Asian financial crisis and after the introduction of capital control by the Malaysian government in its effort to bring the country out of the Asian financial crisis in 1998. In designing the case materials, the economic stimulus package introduced by the Malaysian government during the global economic crisis in 2008 is used to provide a similar scenario as the introduction of the capital control in 1998. Differences in the nature of the Asian financial crisis and the global financial crisis as well as differences in the nature of the Malaysian government's policies during the two crises could limit comparability of this study and that of Gul (2006).



## 6.4 Areas for Future Research

There are a variety of potential avenues for future research that emanate from the research presented in this thesis. First, this research indicates that a client's political connections influence the judgement and decision-making of one of the important participants in the market, i.e., independent auditors. Future research could examine whether a firm's political connections also affect the judgement and decision-making of other market participants such as investors and regulators. Since the findings in prior archival research suggest that a firm's political connections are associated with fraud detection by regulators and influence investors' perceptions, future research could use an experimental approach to validate those findings.

Second, given the potential differences between countries, such as economic, legal system, political, social and cultural differences, future research could investigate whether the results of this study are applicable to other countries. This is especially important as prior studies provide evidence that the influence of political connections on business is prevalent around the world including in developed countries.

Third, given that the findings of this research indicate that a client's political connections have an effect on auditors' judgements, more experimental research should be conducted to examine the effects of a client's political connections on other audit judgements, such as client acceptance decisions and audit opinion decisions.

Fourth, future research could consider using industry specialist and non-industry specialist auditors as participants. The case materials in this study are set in the construction industry. Given the findings in the prior literature that industry specialisation influences auditors' judgements and decision-making, future research

could investigate whether the effect of political connections on auditors' judgements is influenced by the auditor's industry specialisation.

Fifth, future research could consider using different definitions of political connections. In this study a client's political connections are defined in the context of personal connections between the board of directors and politicians or political party. Although this is the most common definition of political connections used in prior research, the use of a different definition of political connections could lead to different outcomes as auditors may perceive that the potential benefits and risks associated with different type of political connections differ. Since a number of studies conducted in countries where firms are required to disclose their political donations to politicians or political parties define a firm's political connections based on their political donations, authors may consider using this alternative definition of political connections.

## APPENDIX 1

### Information Sheet, Consent Form and Voucher Payment Form

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This appendix presents the information sheet, consent form and voucher payment form that are provided to participants.

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## Appendix 1

### (a) Information Sheet



#### **Information Sheet for the Research on Auditors' Judgement and Decision Making Project**

The purpose of this research is to obtain a better understanding of auditor judgements in analysing an audit client and its environment. The study is part of Radzi Jidin's research for his PhD at The Australian National University under the supervision of Professor Gary Monroe from School of Accounting, The University of New South Wales, Australia.

A number of auditors from various firms have been invited to participate in this study. **Your participation in this research is completely voluntary** and you are free to withdraw at any time. The research questionnaire takes approximately 40 minutes to complete. In appreciation of your valuable time spent in participating in the study, you will receive a shopping voucher valued at RM100 if the questionnaire is returned to the researcher within two weeks of receiving the questionnaire.

If you do not return the completed questionnaire to the researcher within 2 weeks, you will be contacted again to see whether you are still interested in participating. If you are still interested in participating, you will be given a further two weeks to complete the questionnaire. A reminder at the end of the first of the two additional weeks and if the researcher still has not received the completed questionnaire after that two weeks period, it will be assumed that the participants have decided to withdraw from the study.

We assure you that all of your responses to the questionnaire will be kept strictly confidential and will be aggregated with those of the other participants before being reported. Your identity will remain anonymous. No reference will be made to any individual or firms and no one will be able to trace the results back to the individual or firms involved in this study. The results obtained from this research will be aggregated before being reported in a PhD thesis, and any journal or conference articles. Your name and contact details will be securely stored in a separate, locked cabinet from the data you supply in the questionnaire. As far as the law allows, any confidential information will be accessible only to the researcher and will be protected by a password. All data will be securely stored by the researcher and destroyed 5 years after the date of collection.

Should you have any questions about the research project please contact me at [r.jidin@unsw.edu.au](mailto:r.jidin@unsw.edu.au) or on +61403 248 314. In Malaysia, you may contact:

Mr Fahmi Ali  
Managing Director  
Virtus Ventures Sdn Bhd  
D8-06-1 Jalan PJU 1A/46  
Pusat Perdagangan Dana 1,  
47301 Petaling Jaya,  
Selangor Darul Ehsan.  
Telephone: 012 5050515  
E-mail: [amdfahmi@gmail.com](mailto:amdfahmi@gmail.com)

Should you have any ethical concerns about this research, you may contact:

Secretary (Human Ethics Research Officer)  
Human Research Ethics Committee  
Research Office, Chancelry 10B  
The Australian National University  
Canberra, ACT 0200.  
Tel: +61 2 612 52900  
Fax: +61 2 612 54807  
Email: [Human.Ethics.Officer@anu.edu.au](mailto:Human.Ethics.Officer@anu.edu.au)

Thank you for your assistance.

Yours sincerely,

.....  
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**Appendix 1**  
**(b) Consent Form**



**Consent Form for Participation in Research on Auditors' Judgement and Decision Making**

I, ....., agree to participate in the research to be conducted by Radzi Jidin. I have read the information sheet provided and understand that:

- The purpose of this research is to obtain a better understanding of auditor judgements in analysing an audit client and its environment.
- Participation in this research is completely voluntary and participants are free to withdraw at any time.
- Participants who complete and return the questionnaire to the researcher within two weeks of receiving the questionnaire will receive an incentive of RM100 (in the form of a shopping voucher).
- The results obtained from this research will be aggregated before being reported in the PhD thesis, and any journal or conference articles.
- My identity will be known only to the researcher and will not appear in or be traceable to any published work.
- My name and contact details will be securely stored in a separate, locked cabinet and will not be traceable from the data (responses) I provide.
- As far as the law allows, any confidential information recorded on computer will be accessible to the researcher only and will be protected by a password.
- Any inquiries concerning the research are to be directed to:

Radzi Jidin  
PhD Candidate  
School of Accounting and Business Information  
Systems  
College of Business and Economics  
Hanna Neumann Building 021  
The Australian National University  
Canberra  
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E-mail: r.jidin@unsw.edu.au



- Inquiries can also be directed to the following Malaysian based contact:  
Mr Fahmi Ali  
Managing Director  
Virtus Ventures Sdn Bhd  
D8-06-1 Jalan PJU 1A/46  
Pusat Perdagangan Dana 1,  
47301 Petaling Jaya,  
Selangor Darul Ehsan.  
Telephone: 012 5050515  
E-mail: amdfahmi@gmail.com
  
- Any ethical concerns about this research, should be directed to:  
Secretary (Human Ethics Research Officer)  
Human Research Ethics Committee  
Research Office, Chancelry 10B  
The Australian National University  
Canberra, ACT 0200.  
Tel: +61 2 612 52900  
Fax: +61 2 612 54807  
Email: Human.Ethics.Officer@anu.edu.au

.....  
Signature

.....  
Date

**Appendix 1**  
**(c) Voucher Payment Form**

Dear Participant,

In order to facilitate the payment of incentive (a shopping voucher valued at RM100), once you have completed the questionnaire, please complete this form.

Please return this form with the completed questionnaire to the researcher.

Name : \_\_\_\_\_

Address : \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Email : \_\_\_\_\_

Phone (optional) : \_\_\_\_\_

Thank you for your assistance

## APPENDIX 2

### Research Instrument

---

The independent variable in this thesis, political connections, is manipulated at three levels, i.e., ruling party connections, opposition party connections and no political connections. This appendix presents the three versions of the experimental materials used in this thesis.

	<u>Version</u>	<u>Page No.</u>
(a)	Ruling Party Connections	198.
(b)	Opposition Party Connections	218
(c)	No Political Connections	238

## **Appendix 2**

### **(a) Ruling Party Connections**

#### **Introduction**

Thank you for participating in this research study. As an auditor, your answers to the attached questionnaire are important in assisting the auditing profession to obtain a better understanding of auditors' judgements in analysing an audit client and its environment. A number of auditors from various audit firms have agreed to voluntarily participate in this study. The study is part of Radzi Jidin's research for his PhD under the supervision of Professor Gary Monroe.

This questionnaire comprises two separate sections, titled SECTION 1 and SECTION 2:

#### **SECTION 1**

- Section 1 is divided into four parts:

##### **Part 1**

- You are provided a description of a corporation, Bright Construction Company (BCC) and its environment. It is a hypothetical case, i.e., it does not represent an actual company. However, every attempt has been made to ensure that the case is as realistic as possible.
- Based on the case description and your experience as an auditor, you are asked to make a number of evaluations of the client. The background information in the case study is not intended to include all of the information that you would normally seek when making similar evaluations in practice. However, for the purpose of this research, please base your judgements on the information provided in the case.

##### **Part 2**

- In this part, you are provided with selected financial information for BCC. You are asked to answer a number of questions based on the background information in Part 1 and the financial information provided in this part.

##### **Part 3**

- In this part, you are asked to make a number of assessments based on the background information in Part 1, the financial information in Part 2 and your experience as an auditor.

##### **Part 4**

- General questions about yourself.

## SECTION 2

- Section 2 is not related to Section 1. Here, we are interested in understanding differences in individual characteristics of auditors.
- In this section, you will be asked to answer a number of questions about yourself.

Please work independently of anyone else. Please carefully follow the instructions provided when recording your answers. We emphasise that we are interested in your responses. There is no correct or incorrect response for each of the tasks. In order for your responses to be usable, it is important that you complete all of the questions.

In appreciation of your valuable time and contribution to this research, you will receive a RM100 shopping voucher. We assure you that all your responses to the questionnaire will be kept strictly confidential and will be aggregated before being reported. Your identity will remain anonymous. No reference will be made to any individual or firms and no one can trace the results back to the individual or firms participated in this study.

Should you have any questions regarding the research at a time following your participation in the study, please do not hesitate to contact Radzi Jidin on (61-2) 93859790 or at [r.jidin@unsw.edu.au](mailto:r.jidin@unsw.edu.au).

If you have any concerns regarding the conduct of this research, you may contact: *Secretary (Human Ethics Research Officer), Human Research Ethics Committee, Research Office, Chancelry 10B, The Australian National University, Canberra, ACT 0200, Tel: +61 2 612 52900, Fax: +61 2 612 54807, Email: [Human.Ethics.Officer@anu.edu.au](mailto:Human.Ethics.Officer@anu.edu.au).*

Thank you very much for your participation in this important research.

Radzi Jidin  
*University of New South Wales and Australian National University*

Professor Gary Monroe  
*University of New South Wales*

## SECTION 1

### PART 1: UNDERSTANDING THE CLIENT AND ITS ENVIRONMENT AND BUSINESS RISK ANALYSIS

#### **THE TASK**

- Assume that you are an audit manager assigned to the audit of Bright Construction Company (BCC) for the year ended December 31, 2009. Your firm has been the independent auditor of BCC for the past 3 years. This is the first time you have been assigned to the audit of BCC.
- As part of the audit, you have been asked to obtain an understanding of BCC and its environment as per Auditing Standard *ISA 315*. You are also required to analyse the client's business risk as stated in *ISA 315*.
- *ISA 315.4(b)* defines business risk as "a risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies".
- Please read the information about BCC below and develop your understanding of BCC and its environment and analyse the company's business risk as required by *ISA 315*.
- *ISA 315* requires the following aspects to be taken into consideration:
  - a. Industry, regulatory and other external factors and the applicable financial reporting framework.
  - b. Nature of the entity.
  - c. The entity's selection and application of accounting policies.
  - d. The entity's objectives and strategies and those related business risks.
  - e. Measurement and review of the entity's financial performance.
  - f. Internal control.
- At the end of Part 1, you will be asked a number of questions based on your understanding of BCC and its environment and your analysis of the company's business risk.



## **Background Information about BCC Berhad**

### ***(i) Business Management and Objectives***

- Ramlee Ahmad founded Bright Construction Company (BCC) in 1985 in Kuala Lumpur. It is a relatively small construction company that conducts its business throughout the country. Currently BCC focuses its projects in a number of states, namely Johor, Negeri Sembilan, Melaka, Perak, Sabah, Sarawak and Federal Territory Kuala Lumpur. It has no overseas operations.
- The company's main business objective is to bid for and win construction contracts and generate profit from the excess of the contract revenue over construction costs.
- A construction boom in Malaysia in the early to middle 1990s provided an opportunity for BCC to expand its operations. Ramlee and his management team listed BCC on the Bursa Malaysia in 1995. Ramlee retained his position as the company's CEO. BCC's Board of Directors consists of seven members including Ramlee.
- Five out of seven board members have a very close relationship with the country's top political leaders at the federal level who are currently in power. They developed the relationship through an active involvement and close association with a political party that is currently the main party in the federal coalition government. For example, the Chairman of the Board, Khairul Hisham, is a former Member of Parliament representing the party for two terms. Two other board members are division leaders of the party in two of the divisions in Pahang. Another member is a division leader in a division in Johor.
- The CEO, Ramlee, is also a very close friend of the country's top political leaders. They have known each other since their university days. For the past 25 years, Ramlee has been a staunch supporter of these leaders.

### ***(ii) Target Market***

- Two market segments targeted by BCC are:
  - (i) Construction of government projects, particularly public infrastructures and utilities such as roads, highways, bridges, schools, government office buildings and water and sewerage management services.
  - (ii) Construction of private projects, mainly commercial buildings such as shopping complexes, retail outlets, warehouses and commercial office buildings.

**(iii) *Accounting and Control Environment***

- The company uses the percentage of completion method to account for its long term construction contracts.
- The previous year's audit work papers indicated that BCC has a good internal control system whereby the strength of internal control environment was assessed as moderate. There was no change to the company's internal control system in the current year under audit.

**(iv) *Debt Covenant***

- BCC has a variety of debt arrangements that are used to finance its business. Many of these arrangements require the company to meet certain debt covenant ratios.
- The most binding requirement is for a minimum Interest Coverage Ratio (EBIT/Interest Expense) of 2:1 in the audited financial statements for the year ended December 31, 2009.
- In the event that BCC breaches any of the covenants, the debt provider may exercise its power to take control of BCC or appoint a Receiver to replace its board and management.

## **Information about Construction Industry**

### **(i) *Competition***

- Construction is a highly competitive industry with many players of different sizes competing. One of the most important steps in the construction process is bidding for construction jobs. Bids are prepared based on budgeted construction costs such as materials, labour and overhead.
- For the past few years, the price of materials such as steel, sand and cement have been rising and this has eroded profit margins, sometimes to single-digit levels. Fluctuations in these costs ultimately influence the company's profit margin.
- All companies are tendering their lowest possible quotations in order to win construction contracts in both the government and private sectors. Many small and medium size companies are struggling to generate sufficient revenue to remain in operation.

### **(ii) *Certificate of Fitness (CF)***

- After completion of a construction project and before the building (infrastructure) can be occupied (used), construction companies need to obtain a certificate of fitness from the local council.
- In order to obtain this certificate, for every project that has been completed, the contractors need to get approval from various government agencies such as the Public Works Department.
- For the construction of government projects, as part of approval process, the Public Works Department continuously monitors the construction projects from the early stage of development until completion. This is to ensure that the project meets all of the specifications stated in the government contracts.
- The ability to obtain approval from the relevant authority is crucial to ensure that the completed project can be delivered to the project's owner on time.
- The inability to deliver construction projects on time can expose the construction companies to potential litigation and adversely affect their reputation. It can lead to a delay in payment and the recognition of revenue.

**(iii) Financing Facilities**

- The lessons learned from the Asian financial crisis in the late 1990s and the failure of a number of private banks due to subprime mortgage crisis in the United States caused banks to be more cautious in providing credit, including credit to companies in the construction industry. Banks tightened their credit policies and put in place stringent credit checks in order to minimise the risk of default by borrowers. BCC found it very hard to obtain loans from private banks in the 2008 and 2009 financial years.
- In a gloomy economic environment, where private banks tend to reduce their financing facilities, many construction companies rely on government-owned banks or banks that are closely linked to government for finance.
- These banks play crucial roles in enhancing the availability of credit facilities. The banks received strong backing from the government to provide financing facilities to selected companies in order to support their operations, avoid potential bankruptcy, which in turn, stimulates the economy.
- For construction companies to successfully deliver the construction projects awarded, the availability of credit facilities from banks is crucial. Failure to secure financing may delay the completion of construction projects. There are also cases where construction companies have to decline construction projects awarded to them due to a lack of financing for the projects.

**(iv) Government Stimulus Plan**

- The global financial crisis caused private companies to reduce their spending and investment activities. In the context of the construction industry, these declines mean that most of the construction projects planned by private companies have been delayed until economic conditions improve. Hence, construction of buildings such as shopping complexes, retail outlets, warehouses and commercial office buildings have been put on hold.
- The decline in construction projects by private companies has adversely affected the construction industry. Many companies have not had new private construction projects in their portfolio since the beginning of the global financial crisis in early 2008. These companies are now running out of funds. In order to remain viable, their only hope is to secure government projects.
- In order to stimulate the domestic economy and to ease the impact of the global financial crisis on Malaysia, the government introduced a number of economic

stimulus initiatives at the end of 2008. One aspect of the stimulus program focuses on increasing government spending for public infrastructure and facilities.

- Around RM20 billion Ringgit has been allocated by the government to fund the construction of various public infrastructure and facilities such as roads, highways, bridges, schools and government office buildings. The government wants most of the allocation to be disbursed as soon as possible in order to stimulate economic growth quickly. The competition among construction firms for construction contracts offered by the government is very intense.
- The government through the Ministry of Finance (MoF) has decided that the decision on tenders for government projects in this stimulus package is not dependent solely on the price offered by the construction firms. Instead, it is at the government's discretion, which takes into consideration various other factors apart from the price tendered.
- BCC has submitted tenders for most of the construction projects offered by the government at the end of 2008. The ability of BCC to secure the government construction projects is crucial to ensure that the company can generate sufficient revenue in the 2009 financial year.







## SECTION 1

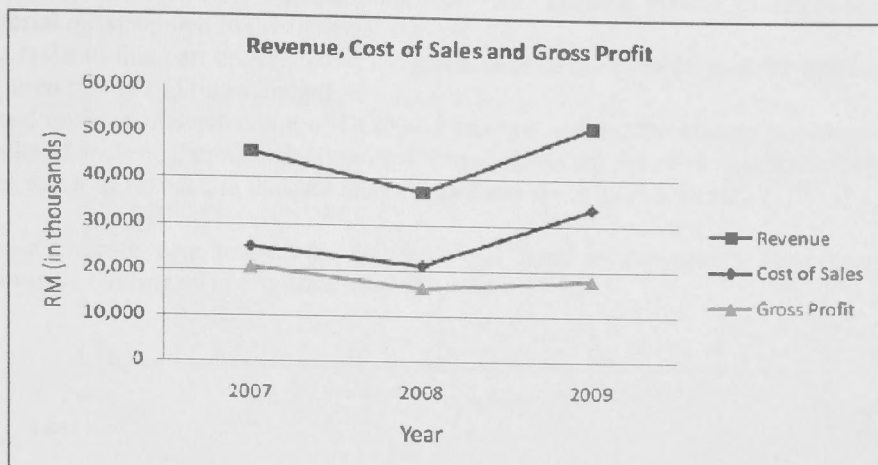
### PART 2: ANALYTICAL PROCEDURES

- Your audit team has performed analytical procedures. These include comparing the client's ratios with the prior years and industry average.
- The unaudited income statement for the year ended 31 December 2009 are provided below together with the audited income statement for the years ended 31 December 2007, 2008.
- You are also provided with a number of ratios calculated based on the 2009 unaudited Income Statement and 2008 and 2007 audited Income Statements.

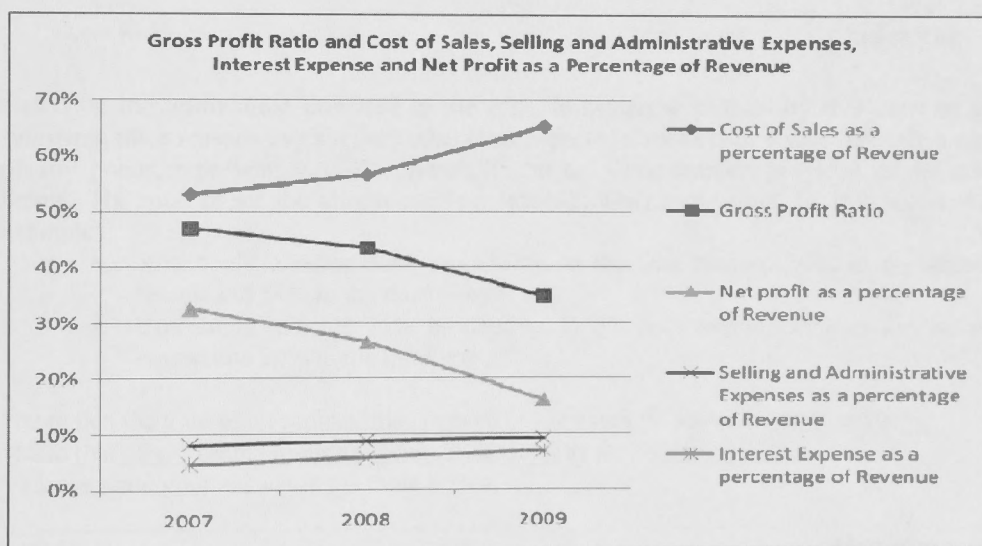
**Bright Construction Company**  
Consolidated Income Statement  
For the years ended December 31, 2009, 2008, 2007  
(in thousands (RM))

	2009 (unaudited)	2008 (audited)	2007 (audited)
Revenue	51,500	37,162	47,245
Cost of Sales	33,600	21,012	25,074
Gross Profit	17,900	16,150	22,171
Selling and administrative expenses	4,716	3,258	3,845
Operating Income	13,184	12,892	18,326
Interest Expense	3,512	2,104	2,153
Profit Before Tax	9,672	10,788	16,173
Income Tax Expense	1,425	932	815
Net Profit (Loss)	8,247	9,856	15,358
Gross Profit Ratio	34.76%	43.46%	46.93%
Cost of Sales as a percentage of Revenue	65.24%	56.54%	53.07%
Selling and Administrative Expenses as a percentage of Revenue	9.16%	8.77%	8.14%
Interest Expense as a percentage of Revenue	6.82%	5.66%	4.56%
Net Profit as a percentage of Revenue	16.01%	26.52%	32.51%
Interest Coverage Ratio	2.35	4.68	7.13

- The graphical representation of Revenue, Cost of Sales and Gross Profit for 2009 (Unaudited), 2008 (Audited) and 2007 (Audited) financial statements are as follows:



- The graphical representation of Gross Profit Ratio as well as Cost of Sales, Selling and Administrative Expenses, Net Profit and Interest Expense as a percentage of Revenue for 2009 (Unaudited), 2008 (Audited) and 2007 (Audited) financial statements are as follows:



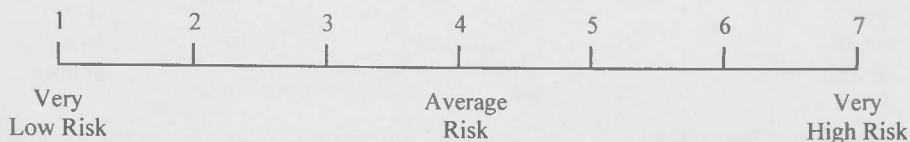
- Your audit team have determined that the fluctuation in the gross profit ratio is considered to be unexpected and material. The results of analytical procedures indicate that BCC's gross profit ratio and the industry average gross profit ratio are as follows:

	2009 (Unaudited)		2008 (Audited)		2007 (Audited)	
	Industry Average	BCC	Industry Average	BCC	Industry Average	BCC
Gross Profit Ratio *	31%	35%	45%	43%	49%	47%

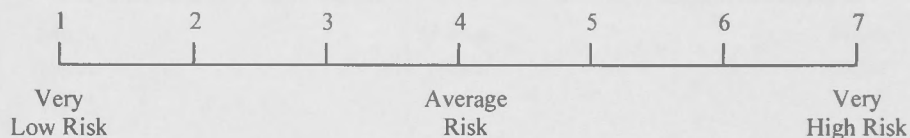
\*Gross Profit Ratio =  $\frac{\text{Revenue} - \text{Cost of Sales}}{\text{Revenue}}$

- According to *ISA240.5*, an auditor “is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatements, whether caused by fraud or error”. In addition, *ISA315.25* requires auditor to assess the risks of material misstatement in the financial statement.
- The tasks in this part are related to the assessment of the risks of material misstatement as required by the auditing standard.
- Based on your understanding of BCC and its environment, the income statements and the results of analytical procedures provided above, please answer all the questions below.
- Feel free to refer back to the case material as many times as you want.

1. Please indicate your assessment of the risk of fraud in this case. [Please provide your answer by circling an appropriate number].



2. Please indicate your assessment of the risk of error in this case. [Please provide your answer by circling an appropriate number].



3. Based on the information provided in the case, indicate the probability that each of the following three reasons explain the higher than expected Gross Profit Ratio. Allocate a total of 100 points, representing 100% probability, to the three reasons provided in the table below. The total of all the allocations (i.e., probabilities) must equal to 100 points. For examples:

- You could allocate 30% probability to the first reason, 20% to the second reason and 50% to the third reason.
- You could allocate 25% probability to the first reason, 55% to the second reason and 20% to the third reason.

\*Note that the total of all probabilities in each of the example above is equal to 100%.

\*Note that other combinations are available as long as they sum to 100%.

\* Please write your answer in the table below.

Potential Reasons	Allocations (i.e. probabilities)
Unintentional errors either made by users of the accounting system or other accounting system error during 2009.	
Fraudulent financial reporting.	
Non-error explanations.	
<b>Total of all of the allocations (i.e., probabilities)</b>	<b>100%</b>

**[Once you have completed this part and move on to the next part, please do not change the answers provided in this part]**

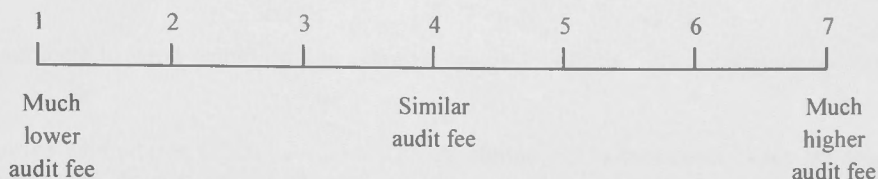
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## SECTION 1

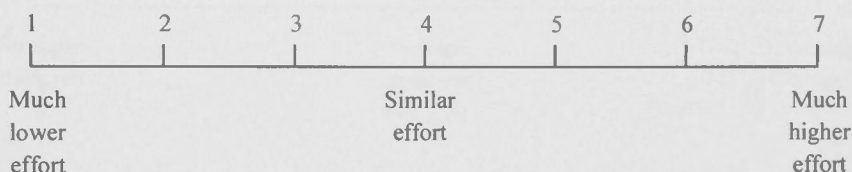
### PART 3: OTHER ASSESSMENTS

- For questions 1 to 4, please provide your answer by circling an appropriate number.

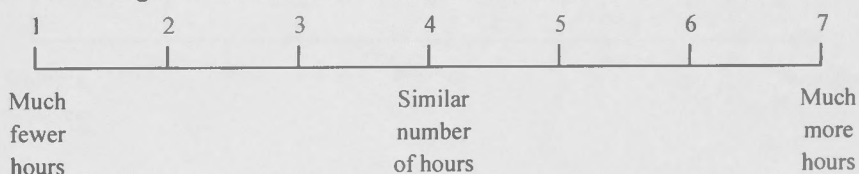
1. How large an audit fee would you recommend that BCC be charged for the audit, compared to a construction client with an average risk of material misstatement and that is of similar size?



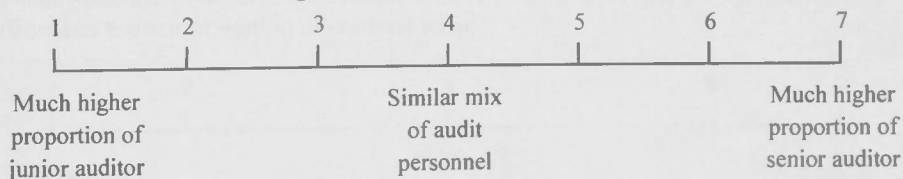
2. How much audit effort would you allocate for the audit of BCC compared to a construction client with an average risk of material misstatement and that is of similar size?



3. How many audit hours would you allocate for the audit of BCC compared to a construction client with an average risk of material misstatement and that is of similar size?



4. What is the mix of audit personnel would you allocate for the audit of BCC compared to a construction client with an average risk of material misstatement and that is of similar size?



5. In the table below, you are provided with current year audit fee figures for two typical clients in the construction industry comparable in size and complexity to BCC together with the assessed level of risk of material misstatement in the financial statements.

Company	Assessed Level of Risk of Material Misstatement	Audit Fees
ABC Berhad	High	RM 99, 337
XYZ Berhad	Low	RM 50,189

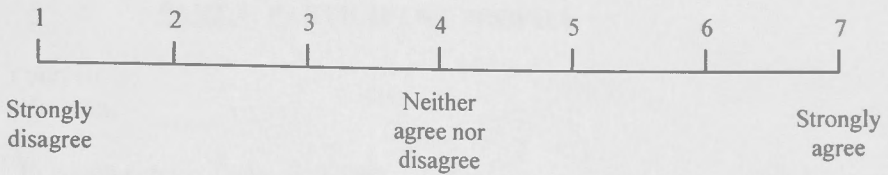
Based on the information above, please indicate the audit fee that you would charge BCC:  
[Please provide your answer in the space provided below].

RM \_\_\_\_\_

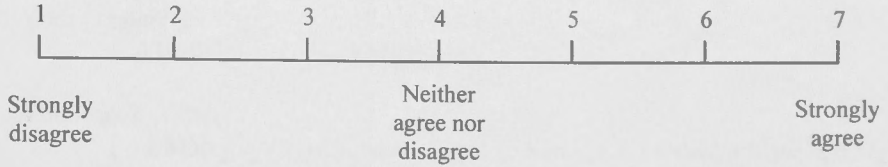




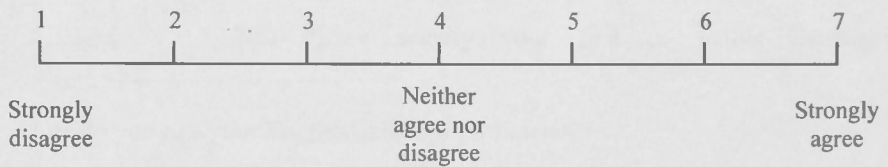
c. In Malaysia, the likelihood of success of any business dealing depends more on who you know rather than what you know.



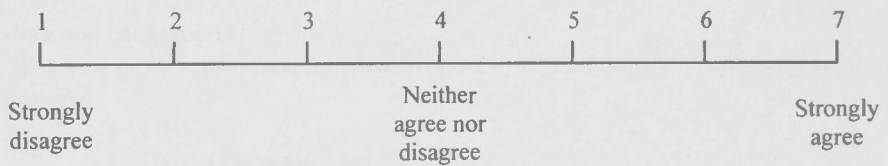
d. In Malaysia, the likelihood of the success of a tender for any government project depends on the strength of connection to political leaders who are currently in power.



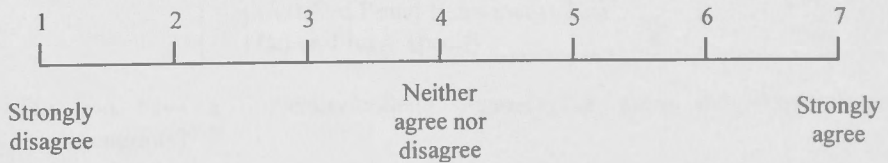
e. In Malaysia, firms that are connected to political leaders who are currently in power are less transparent in their financial reporting compared to unconnected firms.



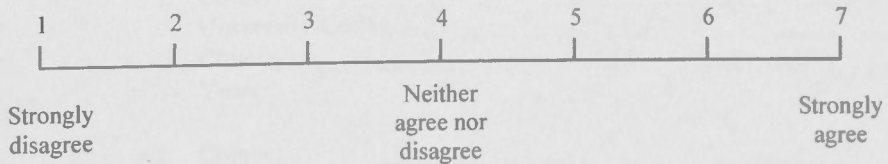
f. In Malaysia, firms that are connected to political leaders who are currently in power have weaker corporate governance systems compared to unconnected firms.



g. In Malaysia, firms that are connected to political leaders who are currently in power are less transparent in business dealings compared to unconnected firms.



h. In Malaysia, firms that are connected to political leaders who are currently in power have weaker internal control systems compared to unconnected firms.



**[Once you have completed this part and move to the next part, please do not change the answers provided in this part]**

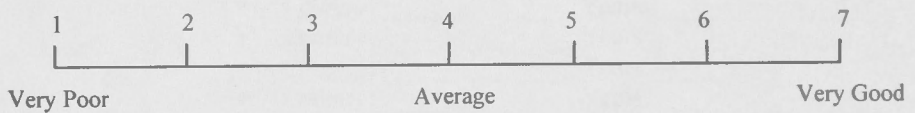
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**SECTION 1**

**PART 4: PARTICIPANT PROFILE**

1. About Yourself

- i. Your age? \_\_\_\_\_ years
- ii. In which country you were born? \_\_\_\_\_
- iii. How long you have been living in Malaysia? \_\_\_\_\_ years
- iv. Your gender?  
 Female       Male
- v. Your race?  
 Malay     Chinese     Indian     Other. Please specify  
\_\_\_\_\_
- vi. Is English your first or native language?  
 Yes  
 No. Please specify your first or native language  
\_\_\_\_\_
- vii. How do you rate your English language proficiency?



2. Your education background

- i. Do you have a professional qualification in accounting or accounting related areas?  
 No  
 Yes. (Please tick)
  - Chartered Accountant (CA)
  - Certified Public Accountant (CPA)
  - Certified Financial Analyst (CFA)
  - Certified Fraud Examiner (CFE)
  - Other. Please specify \_\_\_\_\_
- ii. Do you have a university/college degree(s) or other university/college qualification(s)?  
 No  
 Yes. Please specify all qualifications (if more than two qualifications, please specify the highest two)
  - 1. Course: \_\_\_\_\_  
University/College: \_\_\_\_\_  
Country: \_\_\_\_\_  
Year: \_\_\_\_\_
  - 2. Course: \_\_\_\_\_  
University/College: \_\_\_\_\_  
Country: \_\_\_\_\_  
Year: \_\_\_\_\_

3. Your Professional Background

- i. Your staff level:
- Junior
  - Senior
  - Manager
  - Partner
- ii. How many years/months of auditing experience do you have? \_\_\_ years \_\_\_ months
- iii. How many years/months of working experience do you have? \_\_\_ years \_\_\_ months
- iv. What type of firm you are currently working in?
- "Big-Four" audit firm
  - Medium size or Second Tier audit firm
  - Small audit firm
  - Commercial company
  - Others. Please specify \_\_\_\_\_
- v. Have you ever worked or studied outside Malaysia?
- No
  - Yes. Please specify (if you have been working or studying in more than four countries, please specify four longest stints outside Malaysia:
    - Country: \_\_\_\_\_; Years: \_\_\_\_\_
    - Country: \_\_\_\_\_; Years: \_\_\_\_\_
    - Country: \_\_\_\_\_; Years: \_\_\_\_\_
    - Country: \_\_\_\_\_; Years: \_\_\_\_\_
- vi. What percent of your auditing experience is from auditing clients in the construction industry? \_\_\_\_\_ %
- vii. What is your industry specialisation? \_\_\_\_\_

## SECTION 2

### STATEMENTS DESCRIBING YOURSELF

- Statements that people use to describe themselves are given below. Please circle the response that indicates how you generally feel about yourself. There are no right or wrong answers. Do not spend too much time on any one statement.

	<u>Strongly Disagree</u>					<u>Strongly Agree</u>
I often accept other people's explanations without further thought.	1	2	3	4	5	6
I feel good about myself.	1	2	3	4	5	6
I wait to decide on issues until I can get more information.	1	2	3	4	5	6
The prospect of learning excites me.	1	2	3	4	5	6
I am interested in what causes people to behave the way that they do.	1	2	3	4	5	6
I am confident of my abilities.	1	2	3	4	5	6
I often reject statements unless I have proof that they are true.	1	2	3	4	5	6
Discovering new information is fun.	1	2	3	4	5	6
I take my time when making decisions.	1	2	3	4	5	6
I tend to immediately accept what other people tell me.	1	2	3	4	5	6
Other people's behavior does not interest me.	1	2	3	4	5	6
I am self assured.	1	2	3	4	5	6
My friends tell me that I usually questions things that I see or hear.	1	2	3	4	5	6
I like to understand the reason for other people's behavior.	1	2	3	4	5	6

I think that learning is exciting.	1	2	3	4	5	6
I usually accept things I see, read, or hear at face value.	1	2	3	4	5	6
I do not feel sure of myself.	1	2	3	4	5	6
I usually notice inconsistencies in explanations.	1	2	3	4	5	6
Most often I agree with what the others in my group think.	1	2	3	4	5	6
I dislike having to make decisions quickly.	1	2	3	4	5	6
I have confidence in myself.	1	2	3	4	5	6
I do not like to decide until I've looked at all of the readily available information.	1	2	3	4	5	6
I like searching for knowledge.	1	2	3	4	5	6
I frequently question things that I see or hear.	1	2	3	4	5	6
It is easy for other people to convince me.	1	2	3	4	5	6
I seldom consider why people behave in a certain way.	1	2	3	4	5	6
I like to ensure that I've considered most available information before making a decision.	1	2	3	4	5	6
I enjoy trying to determine if what I read or hear is true.	1	2	3	4	5	6
I relish (i.e. like) learning.	1	2	3	4	5	6
The actions people take and the reasons for those actions are fascinating.	1	2	3	4	5	6

**THANK YOU FOR YOUR PARTICIPATION**

## **Appendix 2**

### **(b) Opposition Party Connections**

#### **Introduction**

Thank you for participating in this research study. As an auditor, your answers to the attached questionnaire are important in assisting the auditing profession to obtain a better understanding of auditors' judgements in analysing an audit client and its environment. A number of auditors from various audit firms have agreed to voluntarily participate in this study. The study is part of Radzi Jidin's research for his PhD under the supervision of Professor Gary Monroe.

This questionnaire comprises two separate sections, titled SECTION 1 and SECTION 2:

#### **SECTION 1**

- Section 1 is divided into four parts:

##### **Part 1**

- You are provided a description of a corporation, Bright Construction Company (BCC) and its environment. It is a hypothetical case, i.e., it does not represent an actual company. However, every attempt has been made to ensure that the case is as realistic as possible.
- Based on the case description and your experience as an auditor, you are asked to make a number of evaluations of the client. The background information in the case study is not intended to include all of the information that you would normally seek when making similar evaluations in practice. However, for the purpose of this research, please base your judgements on the information provided in the case.

##### **Part 2**

- In this part, you are provided with selected financial information for BCC. You are asked to answer a number of questions based on the background information in Part 1 and the financial information provided in this part.

##### **Part 3**

- In this part, you are asked to make a number of assessments based on the background information in Part 1, the financial information in Part 2 and your experience as an auditor.

##### **Part 4**

- General questions about yourself.



## SECTION 2

- Section 2 is not related to Section 1. Here, we are interested in understanding differences in individual characteristics of auditors.
- In this section, you will be asked to answer a number of questions about yourself.

Please work independently of anyone else. Please carefully follow the instructions provided when recording your answers. We emphasise that we are interested in your responses. There is no correct or incorrect response for each of the tasks. In order for your responses to be usable, it is important that you complete all of the questions.

In appreciation of your valuable time and contribution to this research, you will receive a RM100 shopping voucher. We assure you that all your responses to the questionnaire will be kept strictly confidential and will be aggregated before being reported. Your identity will remain anonymous. No reference will be made to any individual or firms and no one can trace the results back to the individual or firms participated in this study.

Should you have any questions regarding the research at a time following your participation in the study, please do not hesitate to contact Radzi Jidin on (61-2) 93859790 or at [r.jidin@unsw.edu.au](mailto:r.jidin@unsw.edu.au).

If you have any concerns regarding the conduct of this research, you may contact: *Secretary (Human Ethics Research Officer), Human Research Ethics Committee, Research Office, Chancelry 10B, The Australian National University, Canberra, ACT 0200, Tel: +61 2 612 52900, Fax: +61 2 612 54807, Email: [Human.Ethics.Officer@anu.edu.au](mailto:Human.Ethics.Officer@anu.edu.au).*

Thank you very much for your participation in this important research.

Radzi Jidin  
*University of New South Wales and Australian National University*

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*University of New South Wales*

## SECTION 1

### PART 1: UNDERSTANDING THE CLIENT AND ITS ENVIRONMENT AND BUSINESS RISK ANALYSIS

#### THE TASK

- Assume that you are an audit manager assigned to the audit of Bright Construction Company (BCC) for the year ended December 31, 2009. Your firm has been the independent auditor of BCC for the past 3 years. This is the first time you have been assigned to the audit of BCC.
- As part of the audit, you have been asked to obtain an understanding of BCC and its environment as per Auditing Standard *ISA 315*. You are also required to analyse the client's business risk as stated in *ISA315*.
- *ISA 315.4(b)* defines business risk as “a risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies”.
- Please read the information about BCC below and develop your understanding of BCC and its environment and analyse the company's business risk as required by *ISA 315*.
- *ISA315* requires the following aspects to be taken into consideration:
  - a. Industry, regulatory and other external factors and the applicable financial reporting framework.
  - b. Nature of the entity.
  - c. The entity's selection and application of accounting policies.
  - d. The entity's objectives and strategies and those related business risks.
  - e. Measurement and review of the entity's financial performance.
  - f. Internal control.
- At the end of Part 1, you will be asked a number of questions based on your understanding of BCC and its environment and your analysis of the company's business risk.

## **Background Information about BCC Berhad**

### ***(i) Business Management and Objectives***

- Ramlee Ahmad founded Bright Construction Company (BCC) in 1985 in Kuala Lumpur. It is a relatively small construction company that conducts its business throughout the country. Currently BCC focuses its projects in a number of states, namely Johor, Negeri Sembilan, Melaka, Perak, Sabah, Sarawak and Federal Territory Kuala Lumpur. It has no overseas operations.
- The company's main business objective is to bid for and win construction contracts and generate profit from the excess of the contract revenue over construction costs.
- A construction boom in Malaysia in the early to middle 1990s provided an opportunity for BCC to expand its operations. Ramlee and his management team listed BCC on the Bursa Malaysia in 1995. Ramlee retained his position as the company's CEO. BCC's Board of Directors consists of seven members including Ramlee.
- Five out of seven board members have a very close relationship with the country's top opposition leaders. They developed the relationship through an active involvement and close association with a political party that is currently the federal opposition. For example, the Chairman of the Board, Khairul Hisham, is a former Member of Parliament representing the opposition party for two terms. Two other board members are division leaders of the opposition party in two of the divisions in Pahang and another member is a division leader in a division in Johor.
- The CEO, Ramlee, is also a very close friend of the country's top opposition leaders. They have known each other since their university days. For the past 25 years, Ramlee has been a staunch supporter of these leaders.

### ***(ii) Target Market***

- Two market segments targeted by BCC are:
  - (i) Construction of government projects, particularly public infrastructures and utilities such as roads, highways, bridges, schools, government office buildings and water and sewerage management services.
  - (ii) Construction of private projects, mainly commercial buildings such as shopping complexes, retail outlets, warehouses and commercial office buildings.

**(iii) *Accounting and Control Environment***

- The company uses the percentage of completion method to account for its long term construction contracts.
- The previous year's audit work papers indicated that BCC has a good internal control system whereby the strength of internal control environment was assessed as moderate. There was no change to the company's internal control system in the current year under audit.

**(iv) *Debt Covenant***

- BCC has a variety of debt arrangements that are used to finance its business. Many of these arrangements require the company to meet certain debt covenant ratios.
- The most binding requirement is for a minimum Interest Coverage Ratio (EBIT/Interest Expense) of 2:1 in the audited financial statements for the year ended December 31, 2009.
- In the event that BCC breaches any of the covenants, the debt provider may exercise its power to take control of BCC or appoint a Receiver to replace its board and management.

## **Information about Construction Industry**

### **(i) *Competition***

- Construction is a highly competitive industry with many players of different sizes competing. One of the most important steps in the construction process is bidding for construction jobs. Bids are prepared based on budgeted construction costs such as materials, labour and overhead.
- For the past few years, the price of materials such as steel, sand and cement have been rising and this has eroded profit margins, sometimes to single-digit levels. Fluctuations in these costs ultimately influence the company's profit margin.
- All companies are tendering their lowest possible quotations in order to win construction contracts in both the government and private sectors. Many small and medium size companies are struggling to generate sufficient revenue to remain in operation.

### **(ii) *Certificate of Fitness (CF)***

- After completion of a construction project and before the building (infrastructure) can be occupied (used), construction companies need to obtain a certificate of fitness from the local council.
- In order to obtain this certificate, for every project that has been completed, the contractors need to get approval from various government agencies such as the Public Works Department.
- For the construction of government projects, as part of approval process, the Public Works Department continuously monitors the construction projects from the early stage of development until completion. This is to ensure that the project meets all of the specifications stated in the government contracts.
- The ability to obtain approval from the relevant authority is crucial to ensure that the completed project can be delivered to the project's owner on time.
- The inability to deliver construction projects on time can expose the construction companies to potential litigation and adversely affect their reputation. It can lead to a delay in payment and the recognition of revenue.

**(iii) Financing Facilities**

- The lessons learned from the Asian financial crisis in the late 1990s and the failure of a number of private banks due to subprime mortgage crisis in the United States caused banks to be more cautious in providing credit, including credit to companies in the construction industry. Banks tightened their credit policies and put in place stringent credit checks in order to minimise the risk of default by borrowers. BCC found it very hard to obtain loans from private banks in the 2008 and 2009 financial years.
- In a gloomy economic environment, where private banks tend to reduce their financing facilities, many construction companies rely on government-owned banks or banks that are closely linked to government for finance.
- These banks play crucial roles in enhancing the availability of credit facilities. The banks received strong backing from the government to provide financing facilities to selected companies in order to support their operations, avoid potential bankruptcy, which in turn, stimulates the economy.
- For construction companies to successfully deliver the construction projects awarded, the availability of credit facilities from banks is crucial. Failure to secure financing may delay the completion of construction projects. There are also cases where construction companies have to decline construction projects awarded to them due to a lack of financing for the projects.

**(iv) Government Stimulus Plan**

- The global financial crisis caused private companies to reduce their spending and investment activities. In the context of the construction industry, these declines mean that most of the construction projects planned by private companies have been delayed until economic conditions improve. Hence, construction of buildings such as shopping complexes, retail outlets, warehouses and commercial office buildings have been put on hold.
- The decline in construction projects by private companies has adversely affected the construction industry. Many companies have not had new private construction projects in their portfolio since the beginning of the global financial crisis in early 2008. These companies are now running out of funds. In order to remain viable, their only hope is to secure government projects.
- In order to stimulate the domestic economy and to ease the impact of the global financial crisis on Malaysia, the government introduced a number of economic



stimulus initiatives at the end of 2008. One aspect of the stimulus program focuses on increasing government spending for public infrastructure and facilities.

- Around RM20 billion Ringgit has been allocated by the government to fund the construction of various public infrastructure and facilities such as roads, highways, bridges, schools and government office buildings. The government wants most of the allocation to be disbursed as soon as possible in order to stimulate economic growth quickly. The competition among construction firms for construction contracts offered by the government is very intense.
- The government through the Ministry of Finance (MoF) has decided that the decision on tenders for government projects in this stimulus package is not dependent solely on the price offered by the construction firms. Instead, it is at the government's discretion, which takes into consideration various other factors apart from the price tendered.
- BCC has submitted tenders for most of the construction projects offered by the government at the end of 2008. The ability of BCC to secure the government construction projects is crucial to ensure that the company can generate sufficient revenue in the 2009 financial year.





## SECTION 1

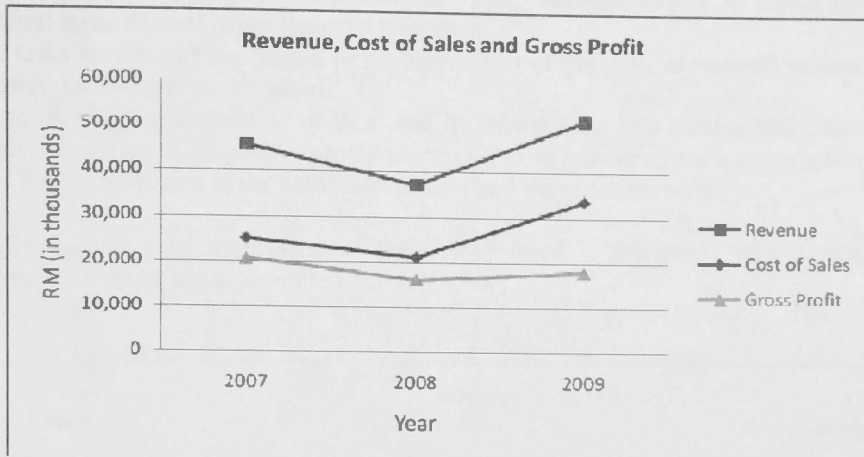
### PART 2: ANALYTICAL PROCEDURES

- Your audit team has performed analytical procedures. These include comparing the client's ratios with the prior years and industry average.
- The unaudited income statement for the year ended 31 December 2009 are provided below together with the audited income statement for the years ended 31 December 2007, 2008.
- You are also provided with a number of ratios calculated based on the 2009 unaudited Income Statement and 2008 and 2007 audited Income Statements.

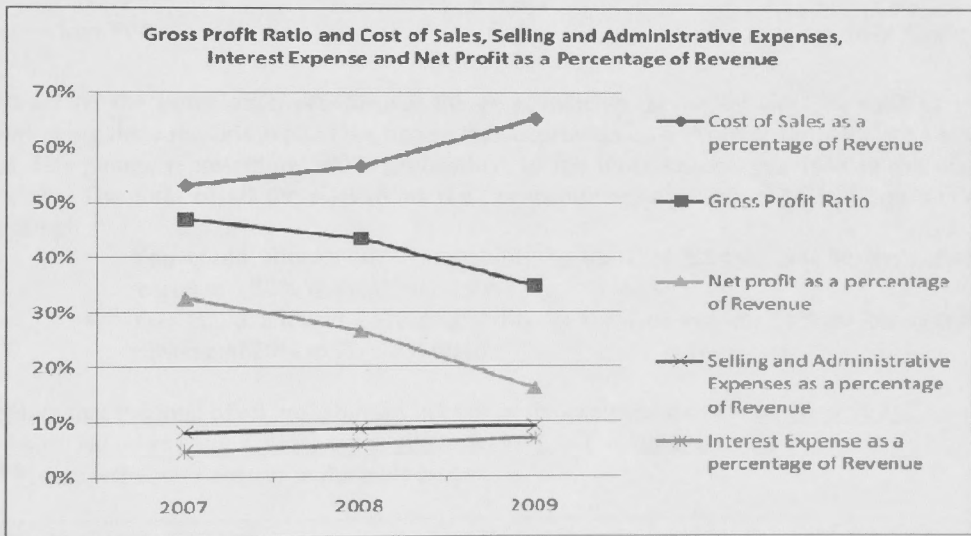
**Bright Construction Company**  
Consolidated Income Statement  
For the years ended December 31, 2009, 2008, 2007  
(in thousands (RM))

	2009 (unaudited)	2008 (audited)	2007 (audited)
Revenue	51,500	37,162	47,245
Cost of Sales	33,600	21,012	25,074
Gross Profit	17,900	16,150	22,171
Selling and administrative expenses	4,716	3,258	3,845
Operating Income	13,184	12,892	18,326
Interest Expense	3,512	2,104	2,153
Profit Before Tax	9,672	10,788	16,173
Income Tax Expense	1,425	932	815
Net Profit (Loss)	8,247	9,856	15,358
Gross Profit Ratio	34.76%	43.46%	46.93%
Cost of Sales as a percentage of Revenue	65.24%	56.54%	53.07%
Selling and Administrative Expenses as a percentage of Revenue	9.16%	8.77%	8.14%
Interest Expense as a percentage of Revenue	6.82%	5.66%	4.56%
Net Profit as a percentage of Revenue	16.01%	26.52%	32.51%
Interest Coverage Ratio	2.35	4.68	7.13

- The graphical representation of Revenue, Cost of Sales and Gross Profit for 2009 (Unaudited), 2008 (Audited) and 2007 (Audited) financial statements are as follows:



- The graphical representation of Gross Profit Ratio as well as Cost of Sales, Selling and Administrative Expenses, Net Profit and Interest Expense as a percentage of Revenue for 2009 (Unaudited), 2008 (Audited) and 2007 (Audited) financial statements are as follows:



- Your audit team have determined that the fluctuation in the gross profit ratio is considered to be unexpected and material. The results of analytical procedures indicate that BCC's gross profit ratio and the industry average gross profit ratio are as follows:

	2009 (Unaudited)		2008 (Audited)		2007 (Audited)	
	Industry Average	BCC	Industry Average	BCC	Industry Average	BCC
Gross Profit Ratio *	31%	35%	45%	43%	49%	47%

\*Gross Profit Ratio =  $\frac{\text{Revenue} - \text{Cost of Sales}}{\text{Revenue}}$



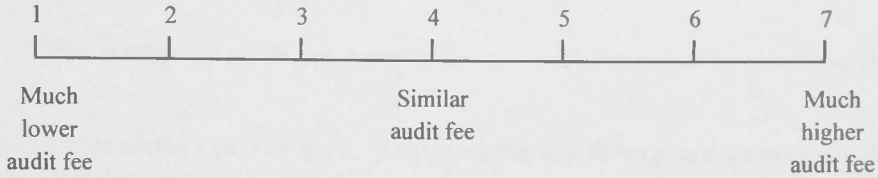


**SECTION 1**

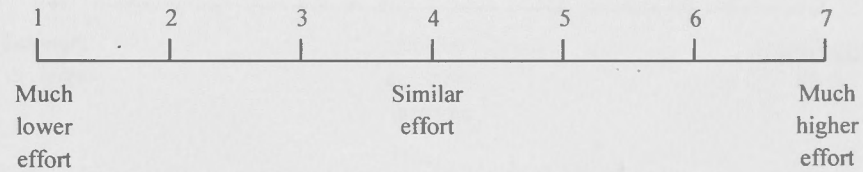
**PART 3: OTHER ASSESSMENTS**

- For questions 1 to 4, please provide your answer by circling an appropriate number.

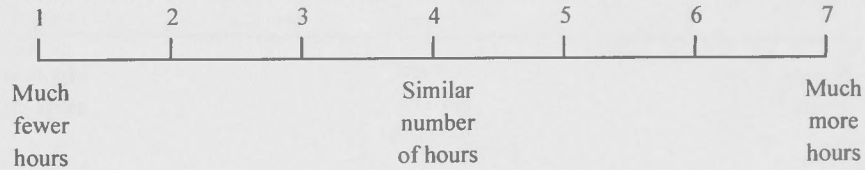
1. How large an audit fee would you recommend that BCC be charged for the audit, compared to a construction client with an average risk of material misstatement and that is of similar size?



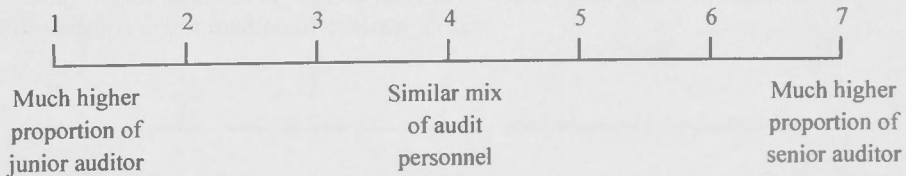
2. How much audit effort would you allocate for the audit of BCC compared to a construction client with an average risk of material misstatement and that is of similar size?



3. How many audit hours would you allocate for the audit of BCC compared to a construction client with an average risk of material misstatement and that is of similar size?



4. What is the mix of audit personnel would you allocate for the audit of BCC compared to a construction client with an average risk of material misstatement and that is of similar size?



5. In the table below, you are provided with current year audit fee figures for two typical clients in the construction industry comparable in size and complexity to BCC together with the assessed level of risk of material misstatement in the financial statements.

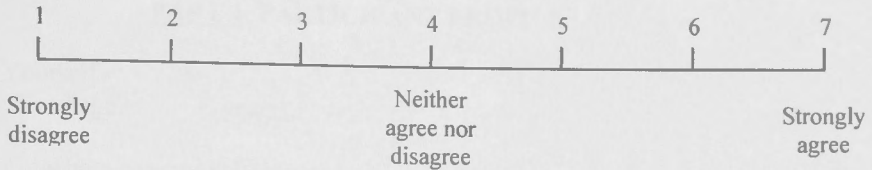
Company	Assessed Level of Risk of Material Misstatement	Audit Fees
ABC Berhad	High	RM 99,337
XYZ Berhad	Low	RM 50,189

Based on the information above, please indicate the audit fee that you would charge BCC:  
[Please provide your answer in the space provided below].

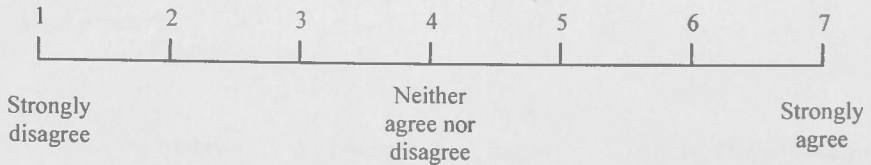
RM \_\_\_\_\_



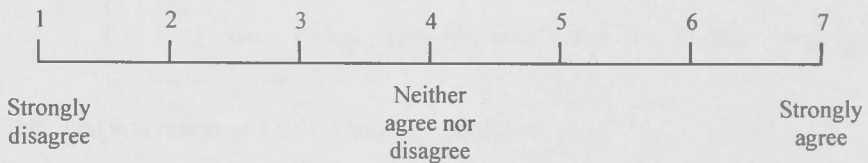
- c. In Malaysia, the likelihood of success of any business dealing depends more on who you know rather than what you know.



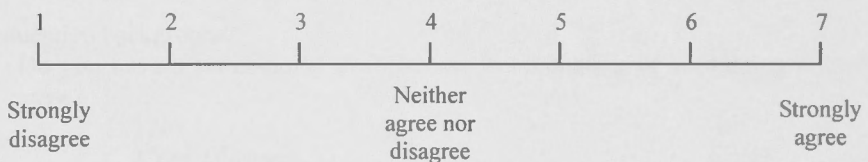
- d. In Malaysia, the likelihood of the success of a tender for any government project depends on the strength of connection to political leaders who are currently in power.



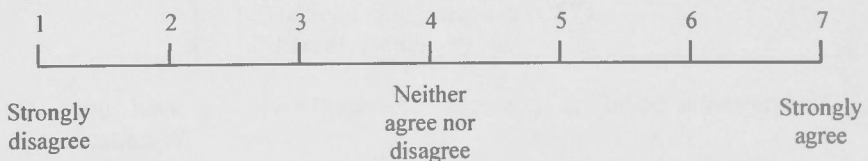
- e. In Malaysia, firms that are connected to political leaders who are currently in power are less transparent in their financial reporting compared to unconnected firms.



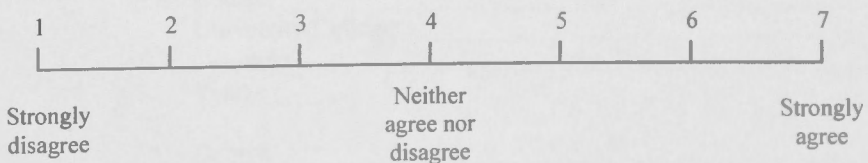
- f. In Malaysia, firms that are connected to political leaders who are currently in power have weaker corporate governance systems compared to unconnected firms.



- g. In Malaysia, firms that are connected to political leaders who are currently in power are less transparent in business dealings compared to unconnected firms.



- h. In Malaysia, firms that are connected to political leaders who are currently in power have weaker internal control systems compared to unconnected firms.



**[Once you have completed this part and move to the next part, please do not change the answers provided in this part]**

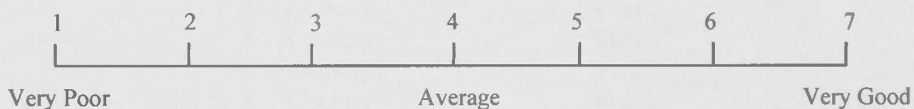
*Please turn over the page when you are ready*

## SECTION 1

### PART 4: PARTICIPANT PROFILE

1. About Yourself

- i. Your age? \_\_\_\_\_ years
- ii. In which country you were born? \_\_\_\_\_
- iii. How long you have been living in Malaysia? \_\_\_\_\_ years
- iv. Your gender?  
 Female       Male
- v. Your race?  
 Malay     Chinese     Indian     Other. Please specify  
\_\_\_\_\_
- vi. Is English your first or native language?  
 Yes  
 No. Please specify your first or native language  
\_\_\_\_\_
- vii. How do you rate your English language proficiency?



2. Your education background

- i. Do you have a professional qualification in accounting or accounting related areas?  
 No  
 Yes. (Please tick)  
 Chartered Accountant (CA)  
 Certified Public Accountant (CPA)  
 Certified Financial Analyst (CFA)  
 Certified Fraud Examiner (CFE)  
 Other. Please specify \_\_\_\_\_
- ii. Do you have a university/college degree(s) or other university/college qualification(s)?  
 No  
 Yes. Please specify all qualifications (if more than two qualifications, please specify the highest two)
  1. Course: \_\_\_\_\_  
University/College: \_\_\_\_\_  
Country: \_\_\_\_\_  
Year: \_\_\_\_\_
  2. Course: \_\_\_\_\_  
University/College: \_\_\_\_\_  
Country: \_\_\_\_\_  
Year: \_\_\_\_\_

3. Your Professional Background

- i. Your staff level:
- Junior
  - Senior
  - Manager
  - Partner
- ii. How many years/months of auditing experience do you have? \_\_\_ years \_\_\_ months
- iii. How many years/months of working experience do you have? \_\_\_ years \_\_\_ months
- iv. What type of firm you are currently working in?
- "Big-Four" audit firm
  - Medium size or Second Tier audit firm
  - Small audit firm
  - Commercial company
  - Others. Please specify \_\_\_\_\_
- v. Have you ever worked or studied outside Malaysia?
- No
  - Yes. Please specify (if you have been working or studying in more than four countries, please specify four longest stints outside Malaysia:
    - Country: \_\_\_\_\_; Years: \_\_\_\_\_
    - Country: \_\_\_\_\_; Years: \_\_\_\_\_
    - Country: \_\_\_\_\_; Years: \_\_\_\_\_
    - Country: \_\_\_\_\_; Years: \_\_\_\_\_
- vi. What percent of your auditing experience is from auditing clients in the construction industry? \_\_\_\_\_ %
- vii. What is your industry specialisation? \_\_\_\_\_

## SECTION 2

### STATEMENTS DESCRIBING YOURSELF

- Statements that people use to describe themselves are given below. Please circle the response that indicates how you generally feel about yourself. There are no right or wrong answers. Do not spend too much time on any one statement.

	<u>Strongly Disagree</u>					<u>Strongly Agree</u>
I often accept other people's explanations without further thought.	1	2	3	4	5	6
I feel good about myself.	1	2	3	4	5	6
I wait to decide on issues until I can get more information.	1	2	3	4	5	6
The prospect of learning excites me.	1	2	3	4	5	6
I am interested in what causes people to behave the way that they do.	1	2	3	4	5	6
I am confident of my abilities.	1	2	3	4	5	6
I often reject statements unless I have proof that they are true.	1	2	3	4	5	6
Discovering new information is fun.	1	2	3	4	5	6
I take my time when making decisions.	1	2	3	4	5	6
I tend to immediately accept what other people tell me.	1	2	3	4	5	6
Other people's behavior does not interest me.	1	2	3	4	5	6
I am self assured.	1	2	3	4	5	6
My friends tell me that I usually questions things that I see or hear.	1	2	3	4	5	6
I like to understand the reason for other people's behavior.	1	2	3	4	5	6



I think that learning is exciting.	1	2	3	4	5	6
I usually accept things I see, read, or hear at face value.	1	2	3	4	5	6
I do not feel sure of myself.	1	2	3	4	5	6
I usually notice inconsistencies in explanations.	1	2	3	4	5	6
Most often I agree with what the others in my group think.	1	2	3	4	5	6
I dislike having to make decisions quickly.	1	2	3	4	5	6
I have confidence in myself.	1	2	3	4	5	6
I do not like to decide until I've looked at all of the readily available information.	1	2	3	4	5	6
I like searching for knowledge.	1	2	3	4	5	6
I frequently question things that I see or hear.	1	2	3	4	5	6
It is easy for other people to convince me.	1	2	3	4	5	6
I seldom consider why people behave in a certain way.	1	2	3	4	5	6
I like to ensure that I've considered most available information before making a decision.	1	2	3	4	5	6
I enjoy trying to determine if what I read or hear is true.	1	2	3	4	5	6
I relish (i.e. like) learning.	1	2	3	4	5	6
The actions people take and the reasons for those actions are fascinating.	1	2	3	4	5	6

**THANK YOU FOR YOUR PARTICIPATION**

## **Appendix 2**

### **(c) No Political Connections**

#### **Introduction**

Thank you for participating in this research study. As an auditor, your answers to the attached questionnaire are important in assisting the auditing profession to obtain a better understanding of auditors' judgements in analysing an audit client and its environment. A number of auditors from various audit firms have agreed to voluntarily participate in this study. The study is part of Radzi Jidin's research for his PhD under the supervision of Professor Gary Monroe.

This questionnaire comprises two separate sections, titled SECTION 1 and SECTION 2:

#### **SECTION 1**

- Section 1 is divided into four parts:

##### **Part 1**

- You are provided a description of a corporation, Bright Construction Company (BCC) and its environment. It is a hypothetical case, i.e., it does not represent an actual company. However, every attempt has been made to ensure that the case is as realistic as possible.
- Based on the case description and your experience as an auditor, you are asked to make a number of evaluations of the client. The background information in the case study is not intended to include all of the information that you would normally seek when making similar evaluations in practice. However, for the purpose of this research, please base your judgements on the information provided in the case.

##### **Part 2**

- In this part, you are provided with selected financial information for BCC. You are asked to answer a number of questions based on the background information in Part 1 and the financial information provided in this part.

##### **Part 3**

- In this part, you are asked to make a number of assessments based on the background information in Part 1, the financial information in Part 2 and your experience as an auditor.

##### **Part 4**

- General questions about yourself.

## SECTION 2

- Section 2 is not related to Section 1. Here, we are interested in understanding differences in individual characteristics of auditors.
- In this section, you will be asked to answer a number of questions about yourself.

Please work independently of anyone else. Please carefully follow the instructions provided when recording your answers. We emphasise that we are interested in your responses. There is no correct or incorrect response for each of the tasks. In order for your responses to be usable, it is important that you complete all of the questions.

In appreciation of your valuable time and contribution to this research, you will receive a RM100 shopping voucher. We assure you that all your responses to the questionnaire will be kept strictly confidential and will be aggregated before being reported. Your identity will remain anonymous. No reference will be made to any individual or firms and no one can trace the results back to the individual or firms participated in this study.

Should you have any questions regarding the research at a time following your participation in the study, please do not hesitate to contact Radzi Jidin on (61-2) 93859790 or at [r.jidin@unsw.edu.au](mailto:r.jidin@unsw.edu.au).

If you have any concerns regarding the conduct of this research, you may contact: *Secretary (Human Ethics Research Officer), Human Research Ethics Committee, Research Office, Chancelry 10B, The Australian National University, Canberra, ACT 0200, Tel: +61 2 612 52900, Fax: +61 2 612 54807, Email: [Human.Ethics.Officer@anu.edu.au](mailto:Human.Ethics.Officer@anu.edu.au).*

Thank you very much for your participation in this important research.

Radzi Jidin  
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- For the construction of government projects, as part of approval process, the Public Works Department continuously monitors the construction projects from the early stage of development until completion. This is to ensure that the project meets all of the specifications stated in the government contracts.
- The ability to obtain approval from the relevant authority is crucial to ensure that the completed project can be delivered to the project's owner on time.
- The inability to deliver construction projects on time can expose the construction companies to potential litigation and adversely affect their reputation. It can lead to a delay in payment and the recognition of revenue.

**(iii) *Financing Facilities***

- The lessons learned from the Asian financial crisis in the late 1990s and the failure of a number of private banks due to subprime mortgage crisis in the United States caused banks to be more cautious in providing credit, including credit to companies in the construction industry. Banks tightened their credit policies and put in place stringent credit checks in order to minimise the risk of default by borrowers. BCC found it very hard to obtain loans from private banks in the 2008 and 2009 financial years.
- In a gloomy economic environment, where private banks tend to reduce their financing facilities, many construction companies rely on government-owned banks or banks that are closely linked to government for finance.
- These banks play crucial roles in enhancing the availability of credit facilities. The banks received strong backing from the government to provide financing facilities to selected companies in order to support their operations, avoid potential bankruptcy, which in turn, stimulates the economy.
- For construction companies to successfully deliver the construction projects awarded, the availability of credit facilities from banks is crucial. Failure to secure financing may delay the completion of construction projects. There are also cases where construction companies have to decline construction projects awarded to them due to a lack of financing for the projects.

**(iv) *Government Stimulus Plan***

- The global financial crisis caused private companies to reduce their spending and investment activities. In the context of the construction industry, these declines mean that most of the construction projects planned by private companies have been delayed until economic conditions improve. Hence, construction of buildings such as shopping complexes, retail outlets, warehouses and commercial office buildings have been put on hold.
- The decline in construction projects by private companies has adversely affected the construction industry. Many companies have not had new private construction projects in their portfolio since the beginning of the global financial crisis in early 2008. These companies are now running out of funds. In order to remain viable, their only hope is to secure government projects.
- In order to stimulate the domestic economy and to ease the impact of the global financial crisis on Malaysia, the government introduced a number of economic

stimulus initiatives at the end of 2008. One aspect of the stimulus program focuses on increasing government spending for public infrastructure and facilities.

- Around RM20 billion Ringgit has been allocated by the government to fund the construction of various public infrastructure and facilities such as roads, highways, bridges, schools and government office buildings. The government wants most of the allocation to be disbursed as soon as possible in order to stimulate economic growth quickly. The competition among construction firms for construction contracts offered by the government is very intense.
- The government through the Ministry of Finance (MoF) has decided that the decision on tenders for government projects in this stimulus package is not dependent solely on the price offered by the construction firms. Instead, it is at the government's discretion, which takes into consideration various other factors apart from the price tendered.
- BCC has submitted tenders for most of the construction projects offered by the government at the end of 2008. The ability of BCC to secure the government construction projects is crucial to ensure that the company can generate sufficient revenue in the 2009 financial year.





## SECTION 1

### PART 2: ANALYTICAL PROCEDURES

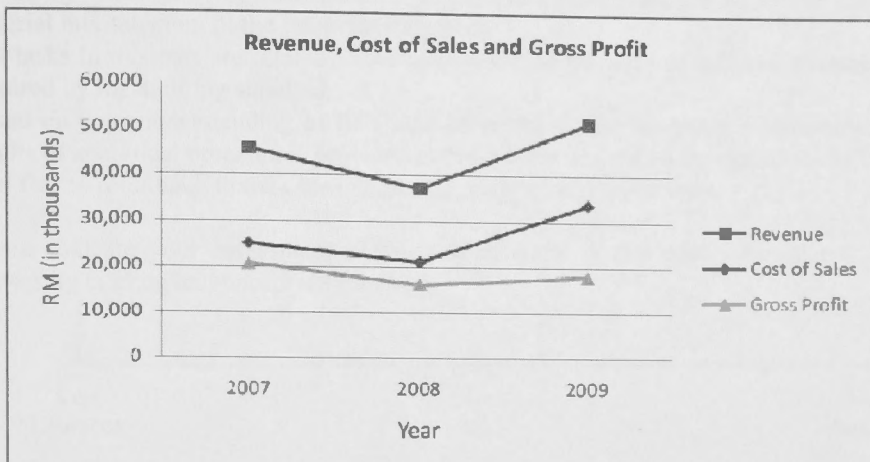
- Your audit team has performed analytical procedures. These include comparing the client's ratios with the prior years and industry average.
- The unaudited income statement for the year ended 31 December 2009 are provided below together with the audited income statement for the years ended 31 December 2007, 2008.
- You are also provided with a number of ratios calculated based on the 2009 unaudited Income Statement and 2008 and 2007 audited Income Statements.

**Bright Construction Company**  
Consolidated Income Statement  
For the years ended December 31, 2009, 2008, 2007  
(in thousands (RM))

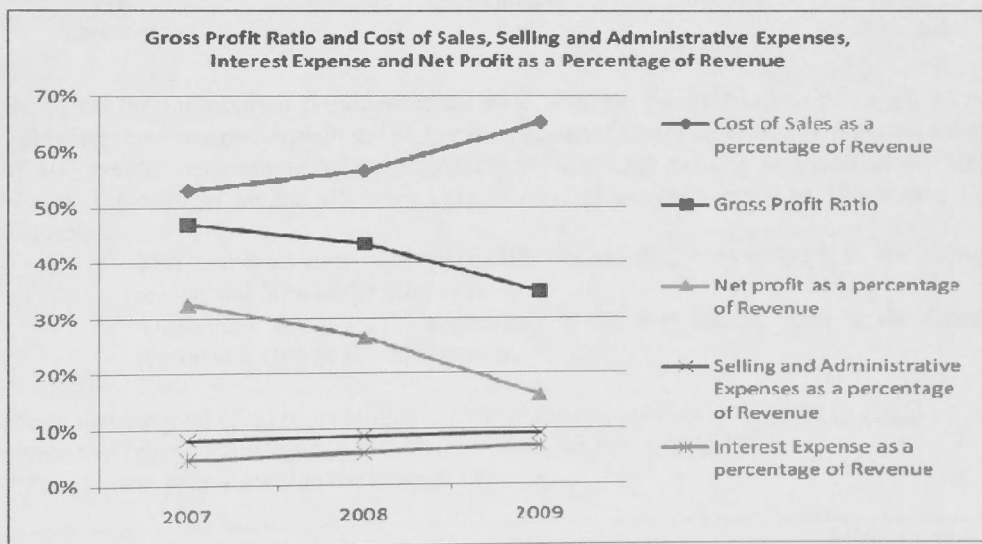
	2009 (unaudited)	2008 (audited)	2007 (audited)
Revenue	51,500	37,162	47,245
Cost of Sales	33,600	21,012	25,074
Gross Profit	17,900	16,150	22,171
Selling and administrative expenses	4,716	3,258	3,845
Operating Income	13,184	12,892	18,326
Interest Expense	3,512	2,104	2,153
Profit Before Tax	9,672	10,788	16,173
Income Tax Expense	1,425	932	815
Net Profit (Loss)	8,247	9,856	15,358
Gross Profit Ratio	34.76%	43.46%	46.93%
Cost of Sales as a percentage of Revenue	65.24%	56.54%	53.07%
Selling and Administrative Expenses as a percentage of Revenue	9.16%	8.77%	8.14%
Interest Expense as a percentage of Revenue	6.82%	5.66%	4.56%
Net Profit as a percentage of Revenue	16.01%	26.52%	32.51%
Interest Coverage Ratio	2.35	4.68	7.13



- The graphical representation of Revenue, Cost of Sales and Gross Profit for 2009 (Unaudited), 2008 (Audited) and 2007 (Audited) financial statements are as follows:



- The graphical representation of Gross Profit Ratio as well as Cost of Sales, Selling and Administrative Expenses, Net Profit and Interest Expense as a percentage of Revenue for 2009 (Unaudited), 2008 (Audited) and 2007 (Audited) financial statements are as follows:



- Your audit team have determined that the fluctuation in the gross profit ratio is considered to be unexpected and material. The results of analytical procedures indicate that BCC's gross profit ratio and the industry average gross profit ratio are as follows:

	2009 (Unaudited)		2008 (Audited)		2007 (Audited)	
	Industry Average	BCC	Industry Average	BCC	Industry Average	BCC
Gross Profit Ratio *	31%	35%	45%	43%	49%	47%

\*Gross Profit Ratio =  $\frac{\text{Revenue} - \text{Cost of Sales}}{\text{Revenue}}$

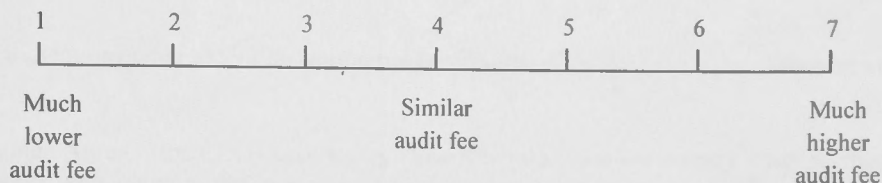


## SECTION 1

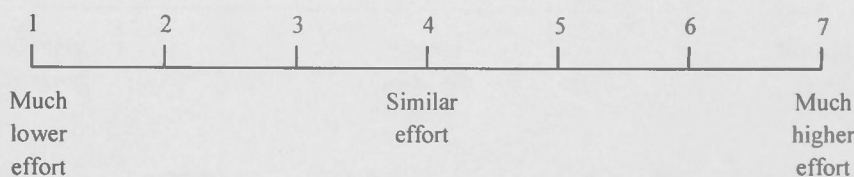
### PART 3: OTHER ASSESSMENTS

- For questions 1 to 4, please provide your answer by circling an appropriate number.

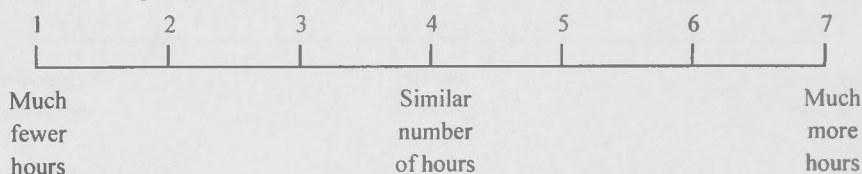
1. How large an audit fee would you recommend that BCC be charged for the audit, compared to a construction client with an average risk of material misstatement and that is of similar size?



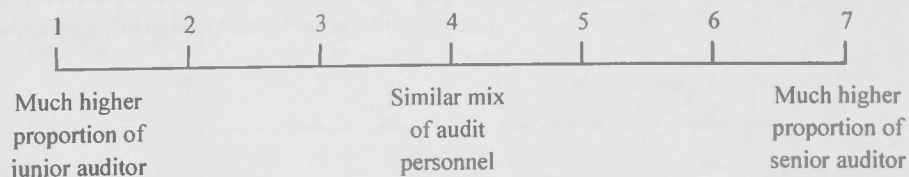
2. How much audit effort would you allocate for the audit of BCC compared to a construction client with an average risk of material misstatement and that is of similar size?



3. How many audit hours would you allocate for the audit of BCC compared to a construction client with an average risk of material misstatement and that is of similar size?



4. What is the mix of audit personnel would you allocate for the audit of BCC compared to a construction client with an average risk of material misstatement and that is of similar size?



5. In the table below, you are provided with current year audit fee figures for two typical clients in the construction industry comparable in size and complexity to BCC together with the assessed level of risk of material misstatement in the financial statements.

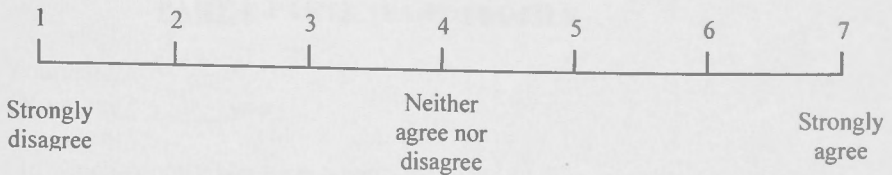
Company	Assessed Level of Risk of Material Misstatement	Audit Fees
ABC Berhad	High	RM 99,337
XYZ Berhad	Low	RM 50,189

Based on the information above, please indicate the audit fee that you would charge BCC:  
[Please provide your answer in the space provided below].

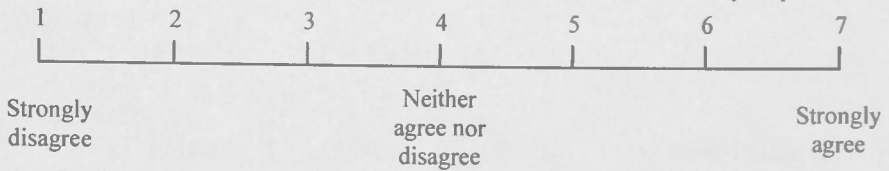
RM \_\_\_\_\_



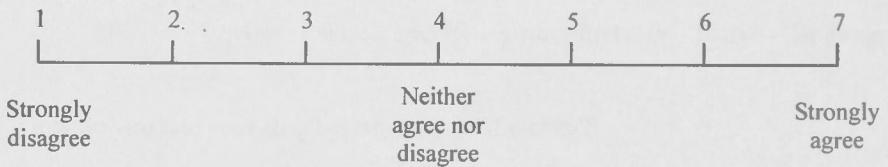
- c. In Malaysia, the likelihood of success of any business dealing depends more on who you know rather than what you know.



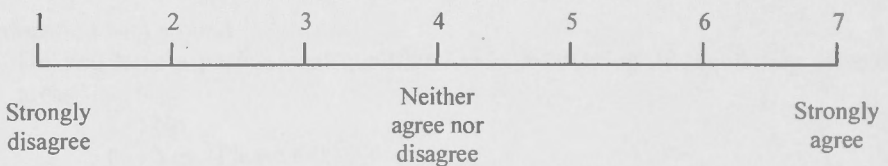
- d. In Malaysia, the likelihood of the success of a tender for any government project depends on the strength of connection to political leaders who are currently in power.



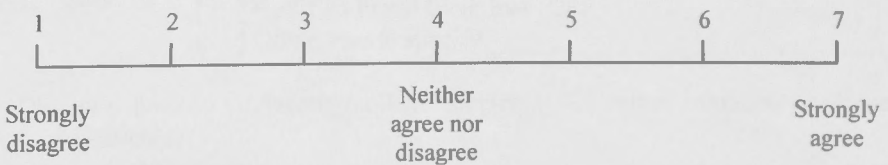
- e. In Malaysia, firms that are connected to political leaders who are currently in power are less transparent in their financial reporting compared to unconnected firms.



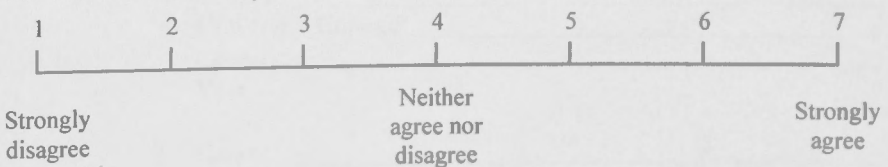
- f. In Malaysia, firms that are connected to political leaders who are currently in power have weaker corporate governance systems compared to unconnected firms.



- g. In Malaysia, firms that are connected to political leaders who are currently in power are less transparent in business dealings compared to unconnected firms.



- h. In Malaysia, firms that are connected to political leaders who are currently in power have weaker internal control systems compared to unconnected firms.



**[Once you have completed this part and move to the next part, please do not change the answers provided in this part]**

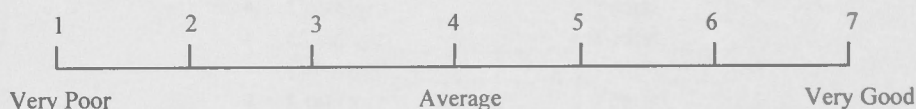
*Please turn over the page when you are ready*

## SECTION 1

### PART 4: PARTICIPANT PROFILE

1. About Yourself

- i. Your age? \_\_\_\_\_ years
- ii. In which country you were born? \_\_\_\_\_
- iii. How long you have been living in Malaysia? \_\_\_\_\_ years
- iv. Your gender?  
 Female       Male
- v. Your race?  
 Malay     Chinese     Indian     Other. Please specify  
\_\_\_\_\_
- vi. Is English your first or native language?  
 Yes  
 No. Please specify your first or native language  
\_\_\_\_\_
- vii. How do you rate your English language proficiency?



2. Your education background

- i. Do you have a professional qualification in accounting or accounting related areas?  
 No  
 Yes. (Please tick)  
 Chartered Accountant (CA)  
 Certified Public Accountant (CPA)  
 Certified Financial Analyst (CFA)  
 Certified Fraud Examiner (CFE)  
 Other. Please specify \_\_\_\_\_
- ii. Do you have a university/college degree(s) or other university/college qualification(s)?  
 No  
 Yes. Please specify all qualifications (if more than two qualifications, please specify the highest two)
  1. Course: \_\_\_\_\_  
University/College: \_\_\_\_\_  
Country: \_\_\_\_\_  
Year: \_\_\_\_\_
  2. Course: \_\_\_\_\_  
University/College: \_\_\_\_\_  
Country: \_\_\_\_\_  
Year: \_\_\_\_\_



3. Your Professional Background

- i. Your staff level:
- Junior
  - Senior
  - Manager
  - Partner
- ii. How many years/months of auditing experience do you have? \_\_\_ years \_\_\_ months
- iii. How many years/months of working experience do you have? \_\_\_ years \_\_\_ months
- iv. What type of firm you are currently working in?
- "Big-Four" audit firm
  - Medium size or Second Tier audit firm
  - Small audit firm
  - Commercial company
  - Others. Please specify \_\_\_\_\_
- v. Have you ever worked or studied outside Malaysia?
- No
  - Yes. Please specify (if you have been working or studying in more than four countries, please specify four longest stints outside Malaysia:
    - Country: \_\_\_\_\_; Years: \_\_\_\_\_
    - Country: \_\_\_\_\_; Years: \_\_\_\_\_
    - Country: \_\_\_\_\_; Years: \_\_\_\_\_
    - Country: \_\_\_\_\_; Years: \_\_\_\_\_
- vi. What percent of your auditing experience is from auditing clients in the construction industry? \_\_\_\_\_ %
- vii. What is your industry specialisation? \_\_\_\_\_

## SECTION 2

### STATEMENTS DESCRIBING YOURSELF

- Statements that people use to describe themselves are given below. Please circle the response that indicates how you generally feel about yourself. There are no right or wrong answers. Do not spend too much time on any one statement.

	<u>Strongly Disagree</u>					<u>Strongly Agree</u>
I often accept other people's explanations without further thought.	1	2	3	4	5	6
I feel good about myself.	1	2	3	4	5	6
I wait to decide on issues until I can get more information.	1	2	3	4	5	6
The prospect of learning excites me.	1	2	3	4	5	6
I am interested in what causes people to behave the way that they do.	1	2	3	4	5	6
I am confident of my abilities.	1	2	3	4	5	6
I often reject statements unless I have proof that they are true.	1	2	3	4	5	6
Discovering new information is fun.	1	2	3	4	5	6
I take my time when making decisions.	1	2	3	4	5	6
I tend to immediately accept what other people tell me.	1	2	3	4	5	6
Other people's behavior does not interest me.	1	2	3	4	5	6
I am self assured.	1	2	3	4	5	6
My friends tell me that I usually questions things that I see or hear.	1	2	3	4	5	6
I like to understand the reason for other people's behavior.	1	2	3	4	5	6

I think that learning is exciting.	1	2	3	4	5	6
I usually accept things I see, read, or hear at face value.	1	2	3	4	5	6
I do not feel sure of myself.	1	2	3	4	5	6
I usually notice inconsistencies in explanations.	1	2	3	4	5	6
Most often I agree with what the others in my group think.	1	2	3	4	5	6
I dislike having to make decisions quickly.	1	2	3	4	5	6
I have confidence in myself.	1	2	3	4	5	6
I do not like to decide until I've looked at all of the readily available information.	1	2	3	4	5	6
I like searching for knowledge.	1	2	3	4	5	6
I frequently question things that I see or hear.	1	2	3	4	5	6
It is easy for other people to convince me.	1	2	3	4	5	6
I seldom consider why people behave in a certain way.	1	2	3	4	5	6
I like to ensure that I've considered most available information before making a decision.	1	2	3	4	5	6
I enjoy trying to determine if what I read or hear is true.	1	2	3	4	5	6
I relish (i.e. like) learning.	1	2	3	4	5	6
The actions people take and the reasons for those actions are fascinating.	1	2	3	4	5	6

**THANK YOU FOR YOUR PARTICIPATION**

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