

## Accepted Manuscript

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PII: S1815-5669(14)00026-5

DOI: <http://dx.doi.org/10.1016/j.jcae.2014.10.001>

Reference: JCAE 59

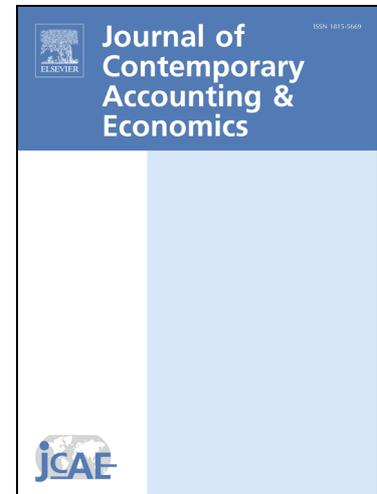
To appear in: *Journal of Contemporary Accounting & Economics*

Received Date: 30 August 2013

Accepted Date: 29 September 2014

Please cite this article as: Wahab, E.A.A., Gist, Willie.E., Majid, W.Z.N., Characteristics of Non-audit Services and Financial Restatements in Malaysia, *Journal of Contemporary Accounting & Economics* (2014), doi: <http://dx.doi.org/10.1016/j.jcae.2014.10.001>

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# Characteristics of Non-audit Services and Financial Restatements in Malaysia

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\*Corresponding author. Effiezal would like to thank Ferdinand Gul, Simon Fung, Bin Srinidhi and Mujtaba Mian for constructive comments during JCAE Research Seminar held at Monash KL 2012 for a different version of paper. Effiezal would like to thank David Hay, Steven Cahan, John Byong-Tek Lee and seminar participants at University of Auckland. Effiezal would like to extend his gratitude to Asheq Rahman for some useful insight. We would like to extend our gratitude to Wan Nordin Wan Hussin and the seminar participants at JCAE 2014 for some comments. Research assistance from Marziana Madah Marzuki and Intan Liyana Mirza are highly appreciated.

# Characteristics of Non-audit Services and Financial Restatements in Malaysia

## Abstract

Various types of purchased non-audit services (NAS) and their recurring nature affect the likelihood of financial statement restatements in Malaysia. Based on 953 firm-year observations during the period 2007 to 2009, evidence of a negative relationship between non-audit fees and financial statement restatements is provided. The purchase of both tax-related and audit-related NAS decreases the likelihood of restatements. Recurring (as opposed to non-recurring) tax-related and audit-related NAS are negatively and significantly related to the likelihood of restatements. These findings support our hypothesis that both types of NAS and their recurrence provide knowledge spillover, which enhances audit and financial reporting quality. When considering institutional settings, we find that politically connected firms are more likely to require financial restatements than non-politically connected firms, while audit committee independence and the purchase of tax-related, recurring tax-related and other NAS decrease this likelihood. The purchase of audit-related and recurring audit-related NAS and non-recurring other NAS decreases the likelihood of restatements for non-politically connected firms.

**Keywords:** Auditor independence, financial restatements, non-audit services, knowledge spillover, audit quality

**JEL Classification:** M42

## 1. Research Aims

Malaysia is not without its fair share of accounting scandals. The Maxbiz Corp Bhd., Transmile Bhd., Megan Media Holdings Bhd. and Tat Sang Bhd. cases signaled accounting irregularities in Malaysia in 2007.<sup>1</sup> These cases indirectly gave a negative view of the role of auditors in preventing fraud. Transmile Bhd. created some stir in the local media, especially with the involvement of a renowned retired political leader from the governing party who was acting as the chairman of the firm.<sup>2</sup> The auditor of Transmile Bhd., Deloitte & Touche, was accused of failure in detecting accounting irregularities dating back to 2004, after a special audit was performed by Moores Rowland Risk Management.<sup>3</sup>

The primary purpose of this study is to investigate the issue of auditor independence in Malaysia.<sup>4</sup> Joint provision of non-audit and audit services by a single auditor has been the subject of numerous studies, as such provision may undermine auditor independence as the economic bond with management increases over time (Francis, 2006). Three research objectives are offered for this study. First, we explore the relationship between non-audit fees and financial statement restatements. Second, we examine the impact of various types of non-audit services (NAS) on financial restatements. Third, we consider whether recurring or non-recurring NAS affect

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<sup>1</sup>Maxbiz Corp Bhd. defaulted on the redemption of stock loans issued to restructure Geahin Engineering Bhd., the company that formed Maxbiz. Transmile Bhd. had a false receivables account, and a market capitalisation of nearly RM 4 billion was reduced to a mere RM 155 million by mid-2007. Megan Media Bhd. suffered massive collusive fraud and raked up debt to RM 1 billion. In 2007, Tat Sang Bhd. inflated the value of its assets and was found guilty of giving false information to the stock exchange for an IPO in 2003.

<sup>2</sup>The retired politician is Tun Dr. Ling Liong Sik. He is currently under investigation for the Port Klang Free Zone scandal, largely due to cost overruns.

<sup>3</sup>Deloitte & Touche also audits Mesdaq-listed firms NasionCom Holdings Bhd. and Ocean Capital Bhd. which were reprimanded in 2007 for submitting inflated revenue figures.

<sup>4</sup>DeAngelo (1981a) defines auditor independence as the conditional probability that auditors will both find and report misrepresentation in financial statements, while Knapp (1985) states that auditor independence is the ability to resist client pressure. Beattie and Fearnley (2002) argue that these definitions reflect on two important element of auditor independence: (i) objectivity, which is the ability to suppress biases, and (ii) integrity, which is the willingness to express an opinion that truthfully reflects the evaluation of what has been discovered during the audit.

financial restatements. The incidence of financial restatements is used as a proxy for financial reporting and audit quality. Malaysia is an excellent choice to test auditor independence since the incumbent statutory auditor can provide NAS (unlike the U.S, for example) and this, in theory, could undermine auditor independence. Furthermore, the Malaysian audit market has not experienced regulatory reforms like those of the US Sarbanes-Oxley Act (2002), and so provides more opportunity to explore the impact of NAS on auditor independence.

To test the robustness of results, the following variables previously tested in Malaysian settings are considered: (1) political connections (Abdul Wahab *et al.*, 2009; Gul, 2006), (2) institutional investors' ownership (Abdul Wahab *et al.*, 2009), (3) Bumiputra directors (Johl *et al.*, 2012) and (4) family firms (Wan-Hussin, 2009). Our choice of variables fills some gaps regarding institutional settings in an audit quality study by Francis (2006). In a study of fraudulent financial reporting, Hasnan *et al.* (2013) recognize that institutional environments in Malaysia with concentrated shareholdings by individuals, families, and significant political connections have substantial implications for the quality of financial reporting.

The subject of NAS and whether they impair auditor independence has been debated over a number of years. Studies (Beattie & Fearnley, 2002; Francis, 2006; Schneider *et al.*, 2006; Walker & Hay, 2013) offer contrasting arguments on how NAS affect auditor independence. The first view is that knowledge spillover from the provision of NAS makes the audit more efficient; the second view is that these services indeed undermine auditor independence. Francis (2006) offers two conjectures of why NAS are inherently problematic for auditors. The first is the possibility that these services compromise auditors' judgment as they move from being an independent outsider to becoming an inside adviser and decision maker; the

second is the increasing economic bond that develops between client and auditor as increasing fees develop reliance on NAS.

Past Malaysian studies that have examined auditor independence (Abdul Wahab *et al.*, 2013; Teoh & Lim, 1996) have failed to take into consideration the characteristics of NAS. Extant literature demonstrates that the characteristics of both type and recurrence have different effects on auditor independence.

Like extant literature on the relationship between non-audit fees and financial restatements (Agrawal & Chadha, 2005; Kinney *et al.*, 2004; Paterson & Valencia, 2011; Raghunandan *et al.*, 2003), we partition non-audit fees into several groups to address the point raised by Simunic (1984) that additional insight may be gained by classifying NAS as specific types rather than treating them as homogeneous. We categorize the NAS into tax-related, audit-related and other NAS. Furthermore, we classify them as to whether they are recurring in nature or not (Paterson & Valencia, 2011). The view of auditor independence by Schneider *et al.* (2006) stresses the importance of identifying the recurrence of NAS as this will enhance our understanding of auditor independence, following the argument raised by Beck *et al.* (1988) that recurring NAS contribute to knowledge spillover that improves auditor independence. In our sample, we consider only incumbent auditors who provide NAS to clients, acknowledging the concern raised by Palmrose (1986) that there should be no joint-supply benefits between audit services supplied by the incumbent firm and NAS supplied by non-incumbent firms.

This study extends the current literature on auditor independence and financial restatements in Malaysia. Teoh and Lim (1996) provide initial evidence of the relationship between non-audit fees and auditor independence in Malaysia. Based on an experimental design, they find that a large audit fee is the single most important

factor leading to impairment of auditor independence, followed by the provision of management consultancy services. Abdul Wahab *et al.* (2013) investigate the relationship between non-audit fees, political connections and going concern audit opinions. They find no evidence to suggest a relationship between non-audit fees and going concern audit opinions. However, they find that firms with high levels of Bumiputra directors are less likely to be issued a going concern audit opinion. Abdul Wahab and Mat Zain (2013) examine audit fees during auditor changes based on a large 1996–2006 data base, and find no evidence that the lowballing of audit fees impairs auditor independence. Abdullah *et al.* (2010) offer the only published study in Malaysia that examines the relationship between corporate governance and financial restatements thus making our study timely. A study by Hasnan *et al.* (2013) examines the influence of various institutional and corporate governance factors on fraudulent financial reporting in Malaysia. While examining the impact of the various types and recurrence of NAS on financial restatements in Malaysia, the present study also controls for institutional and corporate governance variables.

The literature on earnings management is also extended in the present study. Agrawal and Chadha (2005) argue that unlike earnings management that firms routinely engage in at various levels, a misstatement is essentially a direct admission by managers of past manipulation of earnings. There is no ‘smoking gun’ measurement that indicates earnings have indeed been manipulated (Agrawal & Chadha, 2005).

Like Paterson and Valencia (2011), we choose financial restatements as our measure of financial reporting quality and proxy for auditor independence.<sup>5</sup> Users of financial statements and the capital markets rely on the auditor’s expertise and

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<sup>5</sup>Muniandy and Ali (2012) state that four regulators in Malaysia have the duty to review audited reports. They are Companies Commission of Malaysia (CCM), Bursa Malaysia (the local stock exchange), Securities Commission of Malaysia (SC) and Malaysian Institute of Accountants (MIA).

independence to ensure that the quality of financial reporting is maintained. Restatements indicate audit failures (Paterson & Valencia, 2011); therefore, utilizing financial restatements will allow us to examine auditor independence in a more meaningful manner.

Based on 953 firm-year observations for the period 2007 to 2009, we find evidence that the ratio of non-audit fees to total fees affects the likelihood of financial restatements. Upon partitioning non-audit fees, we find that tax-related and audit-related NAS are significantly and negatively related to financial restatements. Likewise, recurring (as opposed to non-recurring) tax-related and audit-related NAS reduce the likelihood of financial restatements.

These findings are similar to those of Kinney *et al.* (2004) and Paterson and Valencia (2011), who suggest that tax-related NAS provide knowledge spillover that improves audit quality and auditor independence. Specifically, Kinney *et al.* (2004) find that large public companies that pay highly for tax services from their auditors tend to have fewer restatements than large public companies that pay less; and Paterson and Valencia (2011) find a significant negative relationship between auditor-provided recurring tax services and financial restatements. Our analysis, too, shows an increase in the likelihood of financial restatements by politically connected firms, which suggests that these firms carry more risk (Gul, 2006) and are deemed to be inefficient (Johnson & Mitton, 2003) in terms of operational activities. Extended analysis of politically connected firms indicate that non-audit fees, tax-related non-audit fees, recurring non-audit fees and recurring tax-related non-audit fees are negatively and significantly related to financial restatements. This suggests that knowledge spillover exists for NAS purchased by politically connected firms. Thus, the purchase of NAS by politically connected firms may be seen as a means to

overcome inefficiency, as indicated by Johnson and Mitton (2003), and lower inherent risk, as suggested by Gul (2006), thereby reducing the incidence of restatements. Our findings also show that the purchase of certain NAS (audit-related, recurring non-audit fees and recurring audit-related) by non-politically connected firms decreases the likelihood of restatements.

Section 2 of this study details a brief institutional background of the Malaysian capital and audit markets. Section 2 also provides a discussion on the development of corporate governance in Malaysia. Section 3 presents the rationale for our developed hypotheses while Section 4 describes the sample selection process. Section 5 discusses the research methodology for this paper. Section 6 presents the results and Section 7 provides an extension to our primary analysis to demonstrate robustness. Section 8 concludes the paper.

## **2. Institutional Background**

### *2.1 Development of Capital Market*

The capital market in Malaysia began with the establishment of the New Economic Policy (NEP) of 1971. This economic policy emphasized the balance of wealth among various ethnic groups, especially between the dominant Malays (henceforth Bumiputras) and the Chinese who then controlled the economy (Gomez & Jomo, 1999). The NEP has made some progress although it is still subject to issues such as cronyism (Gomez & Jomo, 1999; Gul, 2006; Johnson & Mitton, 2003; Salim, 2006), weak professional development (Salim, 2006) and poor management control in terms of executing government contracts (Hamid, 2008). Gomez and Jomo (1999) in their seminal work describe this as positive discrimination, as the NEP was

established to assist the Bumiputras, and especially to increase their share of the capital market.<sup>6</sup>

Malaysia is well known for its relationship-based economy. This is seen from one angle as cronyism, but from another perspective is a means to spark business interest among the Bumiputras and reduce the wealth imbalance among ethnic groups.<sup>7</sup> Faccio *et al.* (2006) find that Malaysia has among the highest number of politically connected firms relative to the size of its capital market, at nearly 20 percent (see Johnson & Mitton, 2003 for a list of politically connected firms). In addition, the Malaysian capital market is plagued with highly levered firms (Bliss & Gul, 2012a, 2012b; Fraser *et al.*, 2006), is highly dependent on various governance codes (Abdul Wahab *et al.*, 2007), has weak enforcement of investor protection, has concentrated ownership (Claessens *et al.*, 2000) and family firms (Wan-Hussin, 2009).

## 2.2 Audit Market in Malaysia

The audit market in Malaysia has seen some major changes since the period of independence.<sup>8</sup> In 1968 the Malaysia Institute of Accountants (MIA) was formed, but its role was minimal until the Investigation and Disciplinary Committee initiated the MIA's Code of Ethics in 1990. Now the audit profession is governed by the MIA By-laws and the Bursa Malaysia Listing Rules and Companies Act of 1965. The Big 4

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<sup>6</sup> White (2004) provides an excellent study of crony capitalism in Malaysia prior to NEP of 1971. The reason for the development of crony capitalism, especially between Chinese businessmen and Bumiputra politicians, was to gain concessions, licences, monopoly rights and government subsidies, and to get protection from foreign competition.

<sup>7</sup> There have been some high-profile (on-going) cases highlighting the result of (possible) cronyism. One is the National Feedlot Corporation (NFC) which is run by a company associated with the then Minister of Women, Family and Community Development and current Chair of UMNO's Women Wing. The RM 250 million allocated for the business by the government has been subject to scrutiny as the company bought assets such as condominiums in Singapore. The entire family of the Minister sits on the board of directors. This case is currently being investigated and the NFC is suspended. UMNO, the United Malays National Organization, is the dominant political party.

<sup>8</sup> See Ali *et al.* (2006) for a review of the development of audit market in Malaysia.

auditors provide audit services to nearly 70 percent of the Bursa Malaysia firms (see Abdul Wahab *et al.*, 2009; Gul, 2006), and mid-tier firms such as BDO Seidman, Grant Thornton and Laventhol & Horwath operate in the local audit market. Among the mechanisms in place to mitigate possible independence issues is audit partner rotation, stipulated by the MIA By-laws; the Listing Rules state that the listed firms need to disclose the amount of NAS purchased. However, the rules and regulations do not require disclosure of the NAS provider, which suggests that incumbent statutory auditors could provide NAS.

The MIA By-laws define independence as independence of mind and independence in appearance (MIA By-laws definitions, paragraph XXXI). This suggests that the auditor's conclusion or opinion in a financial statement audit must not be influenced in a manner that may compromise professional judgment or impair third party judgment about the auditor's professional responsibility.

The MIA By-laws on professional conduct and ethics (revised 2002) suggest that audit firms should not accept any appointment if they are providing NAS to a client, whereby the provision of NAS would create a significant threat to the firm's professional independence, integrity and objectivity; but unlike the US Sarbanes-Oxley Act (2002) rules, there is no specific prohibition on providing certain types of non-audit or non-assurance services to the client.<sup>9</sup> The revised MIA By-laws (paragraph 290.156 to 290.161) explain the ethical rules and guidelines pertaining to providing non-assurance services to audit clients; these rules clearly allow auditors to

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<sup>9</sup> Specifically, Section 201(a) of Sarbanes-Oxley Act of 2002 (SOX) adds Section 10A(g) to the Securities Exchange Act of 1934. Section 10A(g) prohibits a registered public accounting firm from providing certain NAS to their audit clients, including the following: (a) bookkeeping or other services related to the accounting records or financial statements of the audit client; (b) financial information systems design and implementation; (c) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (d) actuarial services; (e) internal audit outsourcing services; (f) management functions or human resources; (g) broker or dealer, investment adviser, or investment banking services; (h) legal services and expert services unrelated to the audit; and (i) any other service that may be determined to be impermissible (Seetharaman *et al.*, 2011).

provide NAS to audit clients at a level that might not be deemed to compromise independence.<sup>10</sup>

### 2.3 *Corporate Governance in Malaysia*

Corporate governance forms an important part of the capital market framework in Malaysia, and was especially important during the Asian Financial Crisis in 1998. The establishment of the Malaysian Code on Corporate Governance (MCCG) in 2000 as part of the stock exchange listing requirements marked an important milestone for corporate reporting requirements. The MCCG went through a revision in 2007 that focused on the qualifications of appointed directors by specifying candidates who had skills, knowledge, expertise, experience, professionalism and integrity, and stressed both the need to document properly all assessments and evaluations carried out by the nominating committee in the discharge of its functions and the need to provide greater disclosure of the issues discussed in board meetings. The revised MCCG emphasized that all members of the audit committee should be financially literate and at least one should be a member of an accounting association or body. In 2007, MCCG required all firms to have an internal audit function. The Listing Requirements of Bursa Malaysia mandate disclosure of whether the internal audit function is performed in-house or is outsourced, and of the costs incurred for the internal audit function in the financial year (Wan-Hussin & Mohammed Bamahros, 2013).

The amendment in 2007 specifies that all members of the audit committee should be non-executive directors. The revised MCCG also requires the audit committee to engage on a continuous basis with senior management, including the chairperson, the

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<sup>10</sup> Para 290.158 of the MIA By-laws states, “before the firm accepts an engagement to provide a non-assurance service to an audit client, a determination shall be made as to whether providing such a service would create a threat to independence. In evaluating the significance of any threat created by a particular non-assurance service, consideration shall be given to any threat that the audit team has reason to believe is created by providing other related non-assurance services. If a threat is created that cannot be reduced to an acceptable level by the application of safeguards, the non-assurance service shall not be provided.”

chief executive officer, the finance director, the head of internal audit and the external auditors. It extends firms' disclosure responsibilities by requiring listed companies to provide more disclosure on (1) matters discussed in the Board and audit committee's meetings, (2) assessments and evaluations carried out by the nominating committee in the discharge of all its functions, and (3) directors' relevant training.

### 3. Research Hypotheses

The primary role of the external auditor is to provide certification and credibility of the financial statements (Agrawal & Chadha, 2005; Fan & Wong, 2005). However, over the last several decades a substantial and increasing portion of accounting firms' total revenues have been derived from consulting services of various kinds. Provision of these NAS can potentially hurt the quality of an audit by impairing auditor independence because of the economic bond that is created between the auditor and the client (Agrawal & Chadha, 2005).

Kinney *et al.* (2004) offer three reasons for a negative relationship between NAS and the likelihood of financial restatements. The first is the subject of knowledge spillover as the NAS provides improved audit effectiveness. For instance, knowledge of a client's computer system or tax accounting could spill over to the audit, enhancing the quality of financial reporting (Kinney *et al.*, 2004). Second, as an analytical model by Dopuch *et al.* (2003) suggests, for clients with high quality financial reporting and low ex ante misstatement risk, the NAS provided by the audit firm may increase the audit firm's reputation capital. This reputation capital, in turn, increases the incentives for audit thoroughness and independence in audit reporting decisions. Third, clients with high quality financial reporting may seek more expert computer system and tax advice, internal audits and other audit-related services, and

may choose their own audit firm as the preferred supplier of such services either because of quality or cost. Any of these reasons suggests a negative relationship between NAS fees and the likelihood of financial restatements.

The economic dependence or bonding argument (Francis, 2006; Kinney *et al.*, 2004) suggests that there is a positive relationship between NAS and the likelihood of financial restatements. A dependence on lucrative NAS fees which increases over time may reduce the auditor's willingness to challenge possible misstatements in a client's financial records and may reduce the likelihood of the auditor detecting misstatements. Agrawal and Chadha (2005) suggest that provision of NAS potentially hurts the quality of audits by impairing auditor independence due to the increase in economic bonding.

We predict a negative relationship between the provision of NAS and the likelihood of financial statement restatements because we believe that auditors' concerns for loss of reputation and exposure to litigation will constrain any desire created by dependence or economic bonding with the client to subordinate their professional judgment to management's wishes. In other words, a more thorough understanding or a more holistic view of the financial reporting system will be achieved when NAS are provided, and is more likely than not to result in knowledge spillover benefits that enhance audit and financial reporting quality. We also expect that because of the nature of the different categories of NAS, examining the different types of NAS individually will provide more meaningful insights into the differential effects on audit effectiveness and auditor independence. Reviews of cumulative research and meta-analysis to date (Habib, 2012; Lim & Tan 2008) conclude that there is evidence based on capital market studies that investors *perceive* that NAS impair independence (i.e., in appearance), but evidence that the provision of NAS

impairs “independence in fact” is weak or non-existent. The first primary hypothesis tested is as follows:

*Hypothesis 1(H<sub>1</sub>): There is a negative relationship between specific types of NAS fees and financial restatements.*

Raghunandan *et al.* (2003) find no evidence to suggest that either NAS fees or total fees inappropriately influences the audit and leads to restatements for 110 US firms during 2000–2001. Similarly, Agrawal and Chadha (2005) find no significant relationship between non-audit fees and financial restatements for 159 US firms that restated their accounts during the 2000–2001 period. Based on 250 US firms that restate their accounts during 2001–2002, obtained from the GAO database, Bloomfield and Shackman (2008) find limited evidence to suggest that firms with higher NAS fees are more likely to restate earnings; they also find a positive and significant relationship between total fees and the probability of financial statement restatements. Huang *et al.* (2007) investigate types of non-audit fees and financial reporting quality. Based on a discretionary accrual model, they find no evidence to suggest that types of non-audit fees affect the quality of financial reporting.

Like Alexander and Hay (2013), Kinney *et al.* (2004) and Paterson and Valencia (2011), we examine the association between types of NAS and financial restatements. The different types of NAS may have different impacts on auditor independence. For instance, the most common auditor-provided NAS is the completion of annual tax returns, and tax compliance services are frequently described as generating knowledge spillover that improves audit effectiveness, increasing auditor independence (Francis, 2006). We expect that certain types of NAS

will have different effects on the probability of financial statement restatements. Knechel and Payne (2001) and Knechel and Sharma (2012) examine the association between types of NAS and audit lag, where audit lag acts as a proxy for auditor independence. Knechel and Payne (2001) examine both management advisory services (MAS) and tax NAS against audit report lag. They find that audit report lag is decreased by the mix of MAS and audit services. Knechel and Sharma (2012) extended the study by examining types of NAS (tax and non-tax fees) against audit report lag before and after establishment of Sarbanes–Oxley Act of 2002 (SOX). They find that tax services are significantly and negatively related to audit report lag.

Based on a larger sample of 432 restating US firms between 1995 and 2000, Kinney *et al.* (2004) investigate the relationship between various types of non-audit fees and financial restatements. They divide NAS into five categories: financial information systems design and implementation, internal audit, audit-related, tax, and unspecified fees. They find a negative and significant relationship between auditor-provided tax services and restatements, but a positive relationship between unspecified fees and restatements, which suggests that auditor-provided tax services increase auditor independence while unspecified fees have the opposite effect. Seetharaman *et al.* (2011) examine the relationship between auditor-provided tax services and tax-related financial statement restatements. Using a sample of 3,888 US restated firm-years during 2003–2005 for 2116 distinct firms, they find no significant association between auditor-provided tax services and general financial statement restatements, but do find a significantly negative relationship between auditor-provided tax services and tax-related financial statement restatements.

An important additional consideration is whether certain NAS are recurring. Beck *et al.* (1988) and Schneider *et al.* (2006) argue that recurring NAS is an

important factor in determining auditor independence. Beck *et al.* (1988) suggest that recurring NAS engagements are expected to generate knowledge spillover that increases audit quality. Chung and Kallapur (2003) suggest that some NAS result in economies of scope and generate cost savings. If such cost savings are shared with the client the auditor's economic bond is decreased. The second primary hypothesis tested is as follows:

*Hypothesis 2(H<sub>2</sub>): There is a negative relationship between specific types of recurring NAS fees and financial restatements.*

Paterson and Valencia (2011) extend the work of Kinney *et al.* (2004) by investigating the impact of recurring and non-recurring non-audit fees on financial restatements. Based on 3,232 restated firm-years in the U.S during 2003–2006, they find a significant negative relationship between auditor-provided recurring tax services and financial restatements. This is consistent with recurring tax services generating knowledge spillover that improves audit quality. Alexander and Hay (2013) find no significant relationship between recurring NAS fees and restatements for a 643 firm-years sample of New Zealand firms between 1995 and 2001. Given such findings and our partitioning of NAS into components, we predict a negative relationship between recurring NAS and the likelihood of financial restatements.

#### **4. Sample Selection**

The sample consists of Bursa Malaysia's listed firms from 2007 to 2009, as presented in Table 1. Consistent with other studies, financial firms are excluded from the sample. The data for NAS were hand collected from annual reports downloaded

from Bursa Malaysia's website. Other hand-collected data from downloaded annual reports are institutional and corporate governance variables. Firm financial characteristics were extracted from Compustat Global. Financial restatements data were obtained from Datastream, and the classification of the types of restatements was derived from the annual reports. Since we are interested in examining the effect of NAS provided by the incumbent auditor on independence, non-incumbent auditors that provide NAS to the client are excluded from the sample.<sup>11</sup> This process results in 953 firm-year observations during 2007–2009.

{Table 1}

## 5. Research Method

The following probit model is posited:

$$\begin{aligned} RESTATE (0,1) = & a_0 INTERCEPT_{it} + a_1 NAF_{it} + a_2 BUMI_{it} + a_3 INSTOWN_{it} + \\ & a_4 POLCON_{it} + a_5 FAMILY_{it} + a_6 INT\_AUDIT_{it} + a_7 AUDCOM_{it} + a_8 BOD\_EXPERT_{it} + \\ & a_9 ASSETS_{it} + a_{10} DEBT\_EQUITY_{it} + a_{11} NEG\_EQUITY_{it} + a_{12} LOSS_{it} + a_{13} BIG\_4_{it} + \\ & a_{14} INDUSTRIES_{it} + a_{15} PERIODS_{it} + e_{it} \end{aligned}$$

### 5.1 Dependent Variable

Financial statement restatements (*RESTATE*) is a dummy variable which takes on the value of 1 if the firm issued a restatement of accounts, and zero otherwise. We classified the financial restatements into several categories based on a review of the annual reports. As in Paterson and Valencia (2011), restatements are categorized as accounting rule application failures (*RESTATE\_AR*), misrepresentation

<sup>11</sup> The results after the inclusion of 36 non-incumbent auditors remain statistically similar.

(*RESTATE\_M*) and irregularities (*RESTATE\_I*).<sup>12</sup> All variables are listed and defined in Table 2.

### 5.2 *Independent Test Variables*

The primary independent variable for this study is NAS. Similar to studies (Bloomfield & Shackman, 2008; Huang *et al.*, 2007; Kinney *et al.*, 2004; Seetharaman *et al.* 2011), non-audit fees deflated by total fees (*NAF*) is our measure for NAS. Non-audit fees are segregated into several types, deflated by total fees which are tax-related NAS (*TAX*), audit-related NAS (*AUDREL*) and other NAS (*OTHERS*). Like Paterson and Valencia (2011), we examine recurring (*NAF\_REC*) and non-recurring NAS (*NAF\_NREC*), recurring (*TAX\_REC*) and non-recurring tax-related NAS (*TAX\_NREC*), recurring (*AUDREL\_REC*) and non-recurring audit-related NAS (*AUDREL\_NREC*), and recurring (*OTHERS\_REC*) and non-recurring other NAS (*OTHERS\_NREC*). Also like them, we use consecutive periods to determine whether the fees for each type of NAS are recurring or non-recurring.<sup>13</sup>

### 5.3 *Independent Institutional Variables*

We consider several institutional variables that are representative of the Malaysian capital market. The first is political connections. Politically connected firms form an important mechanism in Bursa Malaysia. Studies (Gomez & Jomo, 1999; Salim, 2006) suggest that Malaysia presents an interesting example of political development as it is based, historically, on ethnicity. Salim (2006) argues that not

<sup>12</sup> An example of accounting rule application failure is when A&M Realty Bhd. in 2007 was required to restate its accounts after taking into consideration bonus issues. In 2009, A&M Realty was required to restate its accounts to conform with the current year's financial presentation; this is an example of misrepresentation. An example of irregularity is Ann Joo Bhd. which in 2009 restated accounts due to treatment of discontinued operations in financial statements (see Appendix B). A mistake implies unintentional error, whereas irregularities do not. Irregularities may refer to intentional misstatements as in the case of fraud.

<sup>13</sup> Since three years of data are used, we do not consider non-audit fees of similar type that firms purchased in 2007 and then again in 2009 as recurring. The reason for this pattern might be that a different type of NAS was purchased in 2008; or it is possible the data were unavailable in 2008.

only the political economy and capital market, but also the constitution, is largely influenced by racial diversity. Seminal work by Johnson and Mitton (2003) finds that capital control assisted politically connected firms to gain efficiency during the Asian Financial Crisis.

Gul (2006) suggests that auditors will assess politically connected firms as riskier relative to non-politically connected firms and thus result in higher audit fees. Bliss *et al.* (2011) examine whether political connections affect the association of two governance constructs; independent audit committee and CEO duality and the demand for higher quality audits. They find that political connections weakens the demand for higher quality audits by a more independent audit committee. Further, Bliss *et al.* (2011) find that audit firms perceived politically-connected firms with CEO duality as riskier.

A later study by Abdul Wahab *et al.* (2013) finds similar results: they examine the relationship between politically connected firms and the propensity to receive a going concern audit opinion. They find a negative relationship between the proportion of Bumiputra directors, a proxy for political connections, and going concern audit opinions. Hasnan *et al.* (2013) argue that political connection is one of the motivations for fraudulent financial reporting. They argue that quality of earnings may not be salient for politically connected firms since these firms derive gains for their connections. This argument is supported by Riahi-Belkoui (2004), who indicates that gains derived from political connectedness are subject to uncertainty; politically connected firms are able to camouflage their earnings and avoid public scrutiny (Hasnan *et al.*, 2013).

Because of the possibility of political interference, and the risk of future default by these firms that could result in a collapse of the market and of political

protection, we predict a positive relationship between political connections and the likelihood of financial restatements. Political connectedness (*POLCON*) is operationalized as an indicator variable that takes on the value of 1 if the firm is politically connected, and zero otherwise. The lists of politically connected firms gathered by Johnson and Mitton (2003) and Khazanah Nasional Berhad are used.<sup>14</sup>

Our second independent institutional variable is the proportion of Bumiputra directors on the board (*BUMI*).<sup>15</sup> Earlier studies such as those of Haniffa and Cooke (2002, 2005) and Yatim *et al.* (2006) include Bumiputra directors as part of their framework when investigating the relationship between culture, disclosure and audit fees. More recent studies such as Abdul Rahman and Mohammad Ali (2006), Salleh *et al.* (2006), Abdul Wahab *et al.* (2007) and Syed Mustapha Nazri *et al.* (2012) investigate the effect of culture on earnings management, audit quality, corporate governance and auditor choice respectively. As do these studies, the Hofstede-Gray framework was used to establish the relationship between ethnicity and the likelihood of financial restatements. Based on this framework, Haniffa and Cooke (2002, 2005) argue that Bumiputra directors are more secretive in terms of disclosure, relative to the other (Chinese) ethnic group. Their weak accounting disclosures could lead to more audit effort and thus to possible misstatements. Abdul Wahab *et al.* (2007) and Juhl *et al.* (2012) offer a similar argument from the viewpoint of political development in Malaysia. They argue that Bumiputra directors tend to be more politically connected and open for cronyism. These firms might not have the

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<sup>14</sup> Khazanah Nasional Berhad is a Malaysian sovereign wealth fund. It is the investment holding arm of the Government of Malaysia entrusted to hold and manage the commercial assets of the government and to undertake strategic investments. Khazanah was incorporated under the Companies Act 1965 on 3 September 1993 as a public limited company. The share capital of Khazanah is administered by the Minister of Finance, a body corporate incorporated pursuant to the Minister of Finance (Incorporation) Act, 1957.

<sup>15</sup> Bumiputra is a Malaysian term to describe the Malay race and indigenous people of Southeast Asia, particularly in Malaysia. The term comes from the Sanskrit word *bhumiputra*, which can be translated literally as “son of the land” or “son of the soil” (*bhumi*= earth or land, *putra*=son).

motivation to produce good or sound financial reporting as they are supported by the government (Faccio *et al.*, 2006); therefore we predict a positive relationship between the proportion of Bumiputra directors and the likelihood of financial restatements.

The third institutional variable is family firms (*FAMILY*). We operationalize family firms as the proportion of family members on the board of directors. Empirical evidence on family firms in Malaysia is rather limited. Claessens *et al.* (2000) provide initial support on family firms in Malaysia, arguing that firms are controlled by related parties and are owner-managed. Wan-Hussin (2009) examines the relationship between family firms and segment disclosures in Malaysia. He argues that differences in the type I agency problem overwhelm the differences in the type II agency problem between family and non-family firms.<sup>16</sup> Wan-Hussin (2009) observes that family firms have higher disclosure quality, measured by the likelihood of early adoption for segment disclosures in Malaysia. Wang (2006) finds a positive relationship between founding family ownership and quality of earnings. Hasnan *et al.* (2013) find that family ownership is negatively and significantly associated with fraudulent financial reporting. Based on this discussion, a negative relationship between the proportion of family members on the board of directors and financial restatements is predicted.

The fourth and final institutional variable is institutional ownership (*INSTOWN*). The role of institutional investors in Malaysia has increased significantly since the Asian Financial Crisis. A negative relationship between institutional ownership and the likelihood of financial restatements is predicted, as institutional investors are expected to play a more active governance role by either demanding better due professional care from auditors or playing a monitoring role to the board of directors and management. Based on the Malaysian government's initiative in setting

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<sup>16</sup>Type I agency cost refers to manager opportunism or misalignment effects while the Type II agency cost is owner opportunism or entrenchment effects.

up the Minority Shareholder Watchdog Group (MSWG) to protect minority shareholders' interests, institutional shareholders have more initiative to take a governance role and enhance audit quality. Abdul Wahab *et al.* (2007, 2009) and Ammer and Abdul Rahman (2009) present evidence that institutional investors in Malaysia do play an active role in terms of monitoring management. Abdul Wahab *et al.* (2007) examine the relationship between institutional investors and corporate governance in which they find a positive and significant association. Abdul Wahab *et al.* (2009) find a negative relationship between institutional ownership and audit fees, and a significant and negative relationship between political connections and audit fees. Ammer and Abdul Rahman (2009) find significant price reactions for firms targeted by institutional investors.

#### 5.4 *Independent Corporate Governance Variables*

In the spirit of Agrawal and Chadha (2005), several corporate governance variables are considered. First we include the level of independence of audit committee members (*AUDCOM*), which is the proportion of independent directors on the audit committee. Abbott *et al.* (2004) offer two explanations of how independence affects or reduces the likelihood of financial restatements. First, the independence and effectiveness of the internal audit function is strengthened when internal auditors report to an audit committee that does not include a current or former member of management; and second, the audit committee will demand greater external audit scope to avoid being associated with financial restatements. In these situations, the likelihood that the external auditor detects material misstatement is increased (Abbott *et al.*, 2003); hence, we predict a negative relationship between the level of audit committee independence and financial restatements, as was found by Abbott *et al.*

(2004). Baber *et al.* (2012) include the level of independence of audit committee in constructing their measure of internal governance, the B-index<sup>17</sup>, finding a negative relationship between the B-index and financial restatements. Rainsbury *et al.* (2009) examine the relationship between audit committee quality on financial reporting quality and audit fees in New Zealand. Presented with a unique dataset of voluntary formation of audit committee, they find no significant association between the quality of audit committee and the quality of financial reporting quality and little impact on audit fees.<sup>18</sup>

The second corporate governance variable is whether the internal audit function is outsourced.<sup>19</sup> We include an indicator variable, (*INT\_AUDIT*), which takes on the value of 1 if the firm outsources the internal audit function, and zero otherwise. A negative relationship between internal audit outsourcing and financial restatements is expected. We argue that an outsourced internal audit function will increase the level of monitoring and require a higher level of monitoring from the external auditor, and as such will decrease the likelihood of financial restatements, because while internal auditors report to the highest levels of management (and BOD), they still have an economic interest in the viability of the organization and are not independent with respect to it. When the internal audit function is outsourced, there is greater scrutiny because the external auditor has to concern itself with the reliability of the outsourced

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<sup>17</sup> The B-index is a composite measure of six board characteristics:

- (i) Fraction of independent directors on the board
- (ii) Fraction of independent directors on the audit committee
- (iii) Fraction of independent directors on the compensation committee
- (iv) Fraction of independent directors on the nominating committee
- (v) Number of board members
- (vi) CEO duality

<sup>18</sup> Rainsbury *et al.* (2009) identified three membership variables of audit committee. These are:

- (i) Best practice audit committee
- (ii) Audit committee independence
- (iii) Accounting expertise in audit committee

<sup>19</sup> We do not consider internal audit as a non-audit service since it is predominantly provided by non-auditing firms. MIA By-laws prohibit incumbent auditors from providing internal audit services to clients.

organization. Wan-Hussin and Mohammed Bamahros (2013) argue that the role of internal audit function reduces the information asymmetry between managers and various stakeholders. Extant literature on this relationship finds a positive relationship between the internal audit function and audit fees (see Hay *et al.*, 2008; Mohammed *et al.*, 2012). Wan-Hussin and Mohammed Bamahros (2013) find a negative relationship between the cost of internal audit function and audit report delay, but find no similar result when the internal audit function is either outsourced to another party or insourced within the firm.

The third corporate governance variable, (*BOD\_EXPERT*), is the proportion of accounting and finance experts on the board of directors. We predict a negative relationship between *BOD\_EXPERT* and the likelihood of financial restatements. Aier *et al.* (2005) find a negative relationship between chief financial officers who have financial knowledge and financial restatements.

### 5.5 Independent Control Variables

Several control variables established in previous studies of financial restatements are included in the model. The natural log transformation of total assets (*ASSETS*) is used to control for client size. A leverage variable is used to control for default risk among sample firms. Leverage is operationalized as total debt scaled by total equity (*DEBT\_EQUITY*). As in Bliss and Gul (2012a, b), a dummy variable, (*NEG\_EQUITY*), takes on a value of 1 if the firm reports a negative equity, and zero otherwise. It is believed that the inclusion of firms with negative equity will give a broader view of Malaysia's capital market.<sup>20</sup>

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<sup>20</sup> Bliss and Gul (2012a, b) argue that the exclusion of negative equity firms might not reflect the true nature of the Malaysian capital market, especially as the high proportion of politically connected firms that experience negative equity would still be allowed to trade on Bursa Malaysia.

An indicator variable for a Big 4 auditor (*BIG\_4*) controls for audit quality, which may affect the likelihood of restatements. We include a dummy variable (*LOSS*), which takes on the value of 1 if the firm reports negative earnings during the year, and zero otherwise. Finally, industry and year dummies are included in the model to control the effects of these factors.<sup>21</sup>

{Table 2}

### 5.6 Data Description

Total observations during the sample period (2007–2009) are 953. Tables 3 and 3a present the distribution of restatements during the sample period and the distribution of types of restatements, respectively. There are a total of 98 (10.28 percent of total observations) restatements during the sample period: 38 (38.78 percent) occurred during 2007, 7 (7.14 percent) in 2008, and 53 (54.08 percent) in 2009. With respect to yearly distribution, there are 438 observations (restatements and non-restatements) for 2007, 298 for 2008, and 217 for 2009.

{Table 3}

As shown in Table 3a, restatements arising from accounting rules application failure, *Restate\_AR*, represent 30.61 percent (30) of total financial restatements across the three-year period, while restatements arising from accounting irregularities, (*Restate\_I*), account for 17.35 percent (17) and restatements due to misrepresentations, (*Restate\_M*), account for 52.04 percent (51).<sup>22</sup> Tables 3 and 3a show that most of the restatements occurred in 2009.

<sup>21</sup> For the sake of brevity, we do not disclose the results of period and industry dummies. Results are available from the corresponding author.

<sup>22</sup> Please refer to Appendix B for a sample of restatements.

{Table 3a}

Table 4 reports variable means, medians and p-values for differences in means and medians between restatement and non-restatement observations. Panel A of Table 4 reports the results for independent test variables. There are significant median differences for *OTHERS\_REC\_RM* and *OTHERS\_REC*. Panel B of Table 4 presents the results for institutional variables. We find a significant difference for politically connected firms (*POLCON*) as these firms have significantly higher incidence of financial restatements. This gives preliminary support for the proposition that a positive relationship exists between *POLCON* and restatements. However, there are no significant differences between restatement and non-restatement firms for the remaining institutional variables. Panel C presents the differences in means and medians for corporate governance variables, while Panel D presents the results for control variables. No significant differences between restatement and non-restatement firms are observed for corporate governance and control variables.

{Table 4}

In Table 5, the analysis is extended by examining the differences in mean and median for non-audit fees, audit fees and various firm characteristics among different types of financial restatements. Panel A of Table 5 presents the results for non-audit fees, and reveals significant median differences for *TAX\_NREC\_RM* and non-recurring tax-related non-audit fees scaled by total fees (*TAX\_NREC*). We also find marginally significant median differences for audit-related non-audit fees deflated by total fees (*AUDREL*), *OTHERS\_REC\_RM* and *OTHERS\_REC*. There is also a

marginally significant difference for *POLCON* among the different types of financial restatements, as reported in Panel B of Table 5.

{Table 5}

## 6. Results

### 6.1 Univariate Analysis

Table 6 presents both Pearson and Spearman-rank correlations between variables in this study. The correlations between *RESTATE* and *NAF* are -0.074 (Pearson) and -0.064 (Spearman-rank), both significant at the 0.05 level, giving preliminary support to the hypothesis that the purchase of NAS provides knowledge spillover that reduces the likelihood of financial restatements. The correlations between *RESTATE* and *POLCON* are positive and significant for both Pearson (0.071) and Spearman-rank (0.071), giving initial support to the premise that politically connected firms have a higher likelihood of restatements than non-politically connected firms. The highest correlation reported is the Spearman-rank between *AUDREL* and *OTHERS* at -0.737, which is significant at the 0.01 level. The Pearson correlation between *AUDREL* and *OTHERS* is only -0.352, and between *DEBT\_EQUITY* and *NEG\_EQUITY* is -0.497, both significant at the 0.01 level. These findings suggest that firms are likely to purchase a particular type of NAS and firms with negative equity are driven by low level of debt to equity ratio. Other correlations between independent variables are relatively low and do not appear to suggest that multicollinearity is a problem in this study.

{Table 6}

Table 7 presents the results for differences in variable mean and median among different types of non-audit fees, that is, *TAX*, *AUDREL* and *OTHERS*. In Panel A, we observe significant differences across these three for *RESTATE* (the incidence of financial restatements), *NAF\_RM*, *AF\_RM*, *TF\_RM*, *NAF\_REC\_RM* and *NAF\_NREC\_RM*. A similar result is observed for recurring (*NAF\_REC*) non-audit fees deflated by total fees. This indicates that restatements as well as amounts invested on audit fees and recurring or non-recurring non-audit fees are affected by the types of non-audit services purchased. Panel B shows significant differences for institutional variables, indicating variation in the types of NAS due to *BUMI*, *INSTOWN*, *POLCON* and *FAMILY*. Additionally, significant differences are observed for the three corporate governance variables *INT\_AUDIT*, *AUDCOM* and *BOD\_EXPERT* among the various types of NAS purchased, as tabulated in panel C. There are also significant differences for control variables, with the exception of *DEBT\_EQUITY*. Thus, it appears that the incidence of financial restatements is associated with the specific types of purchased NAS, and that in order to reduce the likelihood of an omitted variable problem – institutional, corporate governance and other control variables influencing restatements will need to be considered in a well-specified (i.e., parsimonious) model of financial statement restatements.

{Table 7}

Table 8 tabulates the results for differences in variable mean and median between firms that purchased recurring and non-recurring NAS. We find that firms purchasing recurring NAS paid significantly higher audit fees (*AF\_RM*) and total fees (*TF\_RM*) relative to firms purchasing non-recurring NAS. In addition, there are significant mean differences between recurring and non-recurring firms for tax-related

(*TAX\_RM*) and other (*OTHERS\_RM*) NAS, while a significant median difference for audit-related (*AUDREL\_RM*) NAS.

{Table 8}

## 6.2 Multivariate Analysis

Table 9 tabulates the probit regression results for different types of non-audit fees. Columns 1 and 2 show results of testing *NAF* and various types of *NAF* (*TAX*, *AUDREL* and *OTHERS*). Non-audit fees deflated by total fees (*NAF*) is negatively and significantly related to the likelihood of financial restatements ( $-0.713$ ,  $z=-2.051$ ,  $p<0.05$ ). Analysis of types of *NAF* in Column 2 of Table 9 indicates that tax fees deflated by total fees (*TAX*) is negatively and significantly related to the likelihood of financial restatements ( $-1.370$ ,  $z=-1.754$ ,  $p<0.05$ ). This finding supports the notion that tax-related NAS provide valuable knowledge spillover to the incumbent auditor with respect to understanding the firm better, and leads to better audit quality. This result is consistent with Kinney *et al.* (2004), Paterson and Valencia (2011) and Seetharaman *et al.* (2004). Similar to the finding for *TAX*, there is a negative and significant relationship between *AUDREL* and *RESTATE* ( $-0.840$ ,  $z=-1.622$ ,  $p<0.10$ ), suggesting that audit-related NAS also provide knowledge spillover and thus decrease the frequency of financial restatements.

We find a significantly positive relationship between *POLCON* and *RESTATE*, as shown in column 1 ( $0.265$ ,  $z=2.124$ ,  $p<0.05$ ) and column 2 ( $0.277$ ,  $z=2.218$ ,  $p<0.05$ ), supporting the argument that politically connected firms carry more risk (Gul, 2006) and are driven by inefficiency (Johnson & Mitton, 2003), which could lead to misstatements. However, we find no evidence to support a significant relationship for the remaining three institutional variables.

The regressions also indicate that firms with a higher level of audit committee independence (*AUDCOM*) have a lower likelihood of restating their financial statements, as shown in column 1 ( $-0.007$ ,  $z=-1.785$ ,  $p<0.05$ ) and column 2 ( $-0.007$ ,  $z=-1.746$ ,  $p<0.05$ ). This supports the argument raised by Abbott *et al.* (2004) and Baber *et al.* (2012) that the role of the audit committee is crucial in demanding better monitoring from the external audit to ensure good and sound financial reporting.

{Table 9}

Next, we examine whether recurring or non-recurring non-audit fees have an impact on financial restatements. Column 1 of Table 10 reports that recurring NAS (*NAF\_REC*) are significantly related to financial restatements ( $-0.755$ ,  $z=-1.933$ ,  $p<0.05$ ). This negative relationship supports the argument raised by Beck *et al.* (1988) that recurring NAS contribute to knowledge spillover and improve auditor independence; this finding is also consistent with Paterson and Valencia (2011).

Results shown in column 2 of Table 10 document that recurring tax-related non-audit fees (*TAX\_REC*) have a significant and negative relationship to financial restatements ( $-1.443$ ,  $z=-1.453$ ,  $p<0.10$ ). A similar result is reported in column 5 of Table 10 for *TAX\_REC* ( $-1.779$ ,  $z=-1.674$ ,  $p<0.05$ ). Likewise, Column 5 (which includes all components of non-audit fees and their recurring nature) of Table 10 also shows that recurring audit-related non-audit fees (*AUDREL\_REC*) are negatively and significantly related to the likelihood of financial restatements ( $-0.957$ ,  $z=-1.512$ ,  $p<0.10$ ). These findings suggest that the recurrence of tax-related and audit-related NAS provides some form of audit quality enhancement by reducing the likelihood of financial restatements. Our findings support the argument raised by Beck *et al.* (1988)

and Paterson and Valencia (2011) that recurring NAS provide knowledge spillover that enhances audit effectiveness. *POLCON* and *AUDCOM* are significant and in the expected direction in Table 10 models just as in Table 9 models.

{Table 10}

## 7. Further Analysis

### 7.1 Politically Connected vs. Non-politically Connected Firms

Political connections have been an important determinant in the development of Malaysia's capital market. The literature (see Abdul Wahab *et al.*, 2007, 2009; Gul, 2006; Johnson & Mitton, 2003) emphasizes the importance of investigating its effect in the audit setting. Politically connected firms are known to be highly levered, low in transparency (Faccio *et al.*, 2006), inefficient (Johnson & Mitton, 2003), and high in inherent risk (Gul, 2006); they seem to remain in trading even with negative equity (Bliss & Gul, 2012a, b).

The univariate analysis in Appendix A shows that politically connected firms have significantly higher incidences of financial restatements, non-audit fees (median differences), audit fees and total fees than non-politically connected firms. There are significant differences for tax-related non-audit fees, regardless of recurring nature. For instance, tax-related non-audit fees deflated by total fees (*TAX*), *TAX\_REC* and *TAX\_NREC* are all significantly higher for politically connected firms compared to non-politically connected firms. In addition, politically connected firms have a significantly higher proportion of Bumiputra directors on the board, significantly higher institutional ownership, and a significantly lower proportion of family members on the board. These results are consistent with prior studies (Abdul Wahab *et al.*, 2009, 2013; Gul, 2006). We also find that politically connected firms have a significantly lower percentage of internal audit function outsourcing and a

significantly lower proportion of independent directors on the audit committee. Politically connected firms are significantly larger in size, have greater debt to equity and are less likely to report a loss than non-politically connected firms.

Table 11 presents regression models when the sample is partitioned between politically connected and non-politically connected firms. Columns 1 and 3 show significant and negative relationships between the likelihood of financial restatements and *NAF* ( $-0.630$ ,  $z=-1.364$ ,  $p<0.10$ ) and *TAX* ( $-1.615$ ,  $z=-1.531$ ,  $p<0.10$ ) for politically connected firms; whereas, columns 2 and 4 show significant and negative relationships between the likelihood of financial restatements and *NAF* ( $-0.933$ ,  $z=-1.750$ ,  $p<0.05$ ) and *AUDREL* ( $-1.960$ ,  $z=-1.692$ ,  $p<0.10$ ) for non-politically connected firms. Thus, Table 11 presents additional evidence beyond that reported in Table 9 in that tax-related NAS reduces the likelihood of restatements for politically connected firms, whereas audit-related NAS reduces the likelihood of restatements for non-politically connected firms.

Additionally for Table 11, recurring non-audit fees (*NAF\_REC*) and recurring tax-related non-audit fees (*TAX\_REC*) in columns 5 and 7, respectively, are significantly and negatively related to financial restatements for politically connected firms; and recurring non-audit fees (*NAF\_REC*) and recurring audit-related non-audit fees (*AUDREL\_REC*) in columns 6 and 8, respectively, are significantly and negatively related to financial restatements for non-politically connected firms. This suggests that certain recurring NAS purchased by politically and non-politically connected firms result in knowledge spillover that improves audit and financial reporting quality. Overall, these results highlight the importance of being able to distinguish different types of NAS and their recurrence when examining auditor independence. The proportion of independent directors on the audit committee (*AUDCOM*) represents the

only corporate governance factor that significantly decreases the likelihood of restatements for politically connected firms. With respect to control variables, *LOSS* is positively and significantly related to the incidence of financial restatements for politically connected firms.

{Table 11}

## 8. Conclusion

This study examines the relationship between NAS and the likelihood of financial restatements in Malaysia. Two important characteristics of NAS are taken into account: types of NAS and whether these services are recurring. Evidence is provided that non-audit fees are negatively and significantly related to the likelihood of financial restatements. When non-audit fees are partitioned into components, there is a negative and significant relationship between the likelihood of financial restatements for both tax-related and audit-related non-audit fees. This supports the argument that different types of NAS provide knowledge spillover that enhances audit and financial reporting quality.

In examining the effect of recurrence of the different types of NAS, we find that recurring (as opposed to non-recurring) tax-related and audit-related NAS are negatively and significantly related to the incidence of financial statement restatements. Thus, different types of NAS as well as their recurring nature influence audit effectiveness.

In fulfilling the concern raised by Francis (2006) about controlling for institutional settings, four institutional variables are considered in this study: political connections, family firms, proportion of Bumiputra directors and institutional ownership. We find a positive relationship between politically connected firms and

financial restatements, which suggests that connected firms do carry more risk, as argued by Gul (2006), and are operationally inefficient (Johnson & Mitton, 2003). The analysis is then extended by separating the sample into politically connected and non-politically connected firms. We find that non-audit fees, tax-related non-audit fees, recurring non-audit fees and recurring tax-related non-audit fees are significantly and negatively related to financial restatements for politically connected firms. We also find that non-audit fees, audit-related non-audit fees, recurring non-audit fees and recurring audit-related non-audit fees are significantly and negatively related to restatements for non-politically connected firms. These findings suggest that specific NAS purchased by politically connected firms (i.e., tax-related and recurring tax-related) and non-politically connected firms (i.e., audit-related and recurring audit-related) provide knowledge spillover that improves audit and financial reporting quality.

In the spirit of the extant literature on financial restatements, three corporate governance variables are considered. We find that firms with a higher proportion of independent directors on the audit committee have a lower likelihood of financial restatements. In separate analyses of the proportion of independent directors on the audit committee of politically connected firms versus non-politically connected firms, the increased proportion of independent directors reduces the likelihood of financial restatements for politically connected firms but not for non-politically connected firms. This is an interesting finding since politically connected firms are significantly more likely to have financial restatements than non-politically connected firms in Malaysia.

One limitation of this study is that the recurring nature of NAS is determined over a narrow window of three years. A wider window would likely reduce any

measurement error. The use of only one measure of financial reporting and audit quality (i.e., financial restatements) may be viewed as another limitation because there are many other proxies such as abnormal accruals and the auditor's propensity to qualify audit opinions. The use of multiple proxies for auditor independence could serve as an additional test of robustness, while yielding further insights not possible with the use of a single proxy.

ACCEPTED MANUSCRIPT

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**Table 1: Sample Selection (2007-2009, n=953)**

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Firm-year observations with non-audit fees data	1033
Less Firm-year observations paying non-audit fees to non-incumbent auditors	36
Less Financial firm-year observations	44
Final Sample	<hr/> 953 <hr/>

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Note: Non-incumbent auditors are auditors who provide NAS, but do not provide statutory auditing to existing clients.

Table 2: Operational Definition of Variables

#	Variables	Definitions	Source(s)
1	<i>RESTATE</i>	An indicator variable that takes the value of 1 if the firm restates the financial statements for the fiscal year, zero otherwise	Datastream
<b>Panel A: Independent Test Variables</b>			
2	<i>NAF</i>	Non-audit fees deflated by total fees	Hand collected
3	<i>TAX</i>	Tax related non-audit fees deflated by total fees	Hand collected
4	<i>AUDREL</i>	Audit related non-audit fees deflated by total fees	Hand collected
5	<i>OTHERS</i>	Other services non-audit fees deflated by total fees	Hand collected
6	<i>NAF_REC</i>	Recurring non-audit fees deflated by total fees	Hand collected
7	<i>NAF_NREC</i>	Non-recurring non-audit fees deflated by total fees	Hand collected
8	<i>TAX_REC</i>	Recurring tax related non-audit fees deflated by total fees	Hand collected
9	<i>TAX_NREC</i>	Non-recurring tax related non-audit fees deflated by total fees	Hand collected
10	<i>AUDREL_REC</i>	Recurring Audit-related non-audit fees deflated by total fees	Hand collected
11	<i>AUDREL_NREC</i>	Non-Recurring Audit-related non-audit fees deflated by total fees	Hand collected
10	<i>OTHERS_REC</i>	Recurring other services non-audit fees deflated by total fees	Hand collected
11	<i>OTHERS_NREC</i>	Non-recurring other services non-audit fees deflated by total fees	Hand collected
<b>Panel B: Independent Institutional Variables</b>			
12	<i>BUMI</i>	Proportion of Bumiputra directors on board of directors	Hand collected
13	<i>INSTOWN</i>	% ownership by top 5 institutional investors	Hand collected
14	<i>POLCON</i>	An indicator variable that takes the value of 1 if the firm is politically-connected, zero otherwise	Johnson and Mitton (2003) and Khazanah Bhd website.
15	<i>FAMILY</i>	The proportion of family members on the board of directors	Hand collected
<b>Panel C: Independent Corporate Governance Variables</b>			
16	<i>INT_AUDIT</i>	An indicator variable that takes the value of 1 if the firm outsources its internal audit function, zero otherwise	Hand collected
17	<i>AUDCOM</i>	The proportion of independent directors on the audit committee	Hand collected
18	<i>BOD_EXPERT</i>	The proportion of accounting and finance expertise on board of directors	Hand collected
<b>Panel D: Independent Control Variables</b>			
13	<i>ASSETS</i>	Natural log transformation of total assets	Compustat Global, missing data hand collected
14	<i>DEBT_EQUITY</i>	Total debt deflated by total equity	Compustat Global, missing data hand collected
15	<i>NEG_EQUITY</i>	An indicator variable that takes the value of 1 if the firm recorded a negative equity during the sample period, zero otherwise	Compustat Global, missing data hand collected
18	<i>LOSS</i>	An indicator variable that takes the value of 1 if the firm records a loss during the year, zero otherwise	Compustat Global, missing data hand collected
20	<i>BIG_4</i>	An indicator variable that takes on the value of 1 if the auditor is a Big 4 auditor, zero otherwise	Hand collected

Hand collected means hand collected from annual reports.

**Table 3: Distribution of Financial Restatements (2007-2009, n=953)**

	2007	Year (%)	Restate (%)	2008	Year (%)	Restate (%)	2009	Year (%)	Restate (%)	Total (%)	Total (%)	
Restatements	38	8.68	38.78	7	2.35	7.14	53	24.42	54.08	100.00	98	10.28
Non-restatements	400	91.32	46.78	291	97.65	34.04	164	75.58	19.18	100.00	855	89.72
	438		45.96	298		31.27	217		22.77		953	100.00

**Table 3a: Distribution of Types of Restatements (2007-2009, n=98)**

Types of Restatements	2007	Year (%)	Types (%)	2008	Year (%)	Types (%)	2009	Year (%)	Types (%)	Total (%)	Total (%)	
Restate_AR	7	18.42	23.33	2	28.57	6.67	21	39.62	70.00	100.00	30	30.61
Restate_I	7	18.42	41.18	4	57.14	23.53	6	11.32	35.29	100.00	17	17.35
Restate_M	24	63.16	47.06	1	14.29	1.96	26	49.06	50.98	100.00	51	52.04
	38	100.00		7	100.00		53	100.00			98	100.00

Restate\_AR is restatements due to accounting rules application failure; Restate\_I is restatements due to accounting irregularities; and Restate\_M is restatements due to misrepresentations.

**Table 4: Differences in Variable Mean and Median between Restatement and Non-restatement Firms (2007-2009, n=953)**

	Restate=1 Mean	(n=98) Median	Restate=0 Mean	(n=855) Median	t-test p-value	Mann- Whitney p-value
<b>Panel A: Independent Test Variables</b>						
<i>NAF_RM</i>	68121.255	18725.000	171971.800	25000.000	0.186	0.123
<i>AF_RM</i>	231047.112	120850.000	330857.195	120000.000	0.374	0.861
<i>TF_RM</i>	299168.367	157040.000	502828.995	162384.000	0.207	0.661
<i>TAX_RM</i>	4195.929	0.000	59877.959	0.000	0.322	0.750
<i>AUDREL_RM</i>	36743.418	0.000	52657.411	0.000	0.680	0.101
<i>OTHERS_RM</i>	27181.908	5250.000	59436.430	3000.000	0.419	0.197
<i>NAF_REC_RM</i>	55553.245	10000.000	130825.126	10000.000	0.289	0.880
<i>NAF_NREC_RM</i>	12568.010	0.000	41146.674	0.000	0.292	0.229
<i>TAX_REC_RM</i>	2005.796	0.000	55529.242	0.000	0.339	0.554
<i>TAX_NREC_RM</i>	2190.133	0.000	4348.717	0.000	0.661	0.764
<i>AUDREL_REC_RM</i>	32308.908	0.000	26129.026	0.000	0.812	0.523
<i>AUDREL_NREC_RM</i>	4434.510	0.000	26528.385	0.000	0.411	0.403
<i>OTHERS_REC_RM</i>	21238.541	2500.000	49166.858	0.000	0.485	<b>0.044</b>
<i>OTHERS_NREC_RM</i>	5943.367	0.000	10269.572	0.000	0.450	0.535
<i>TAX</i>	0.015	0.000	0.029	0.000	0.183	0.753
<i>AUDREL</i>	0.058	0.000	0.081	0.000	0.141	0.114
<i>OTHERS</i>	0.104	0.053	0.110	0.017	0.684	0.254
<i>NAF_REC</i>	0.131	0.085	0.149	0.080	0.295	0.994
<i>NAF_NREC</i>	0.045	0.000	0.071	0.000	<b>0.096</b>	0.203
<i>TAX_REC</i>	0.010	0.000	0.022	0.000	0.206	0.561
<i>TAX_NREC</i>	0.005	0.000	0.007	0.000	0.678	0.765
<i>AUDREL_REC</i>	0.039	0.000	0.050	0.000	0.354	0.501
<i>AUDREL_NREC</i>	0.019	0.000	0.031	0.000	0.298	0.386
<i>OTHERS_REC</i>	0.082	0.017	0.077	0.000	0.703	<b>0.048</b>
<i>OTHERS_NREC</i>	0.021	0.000	0.033	0.000	0.270	0.538
<b>Panel B: Independent Institutional Variables</b>						
<i>BUMI</i>	0.416	0.423	0.423	0.429	0.697	0.565
<i>INSTOWN</i>	10.294	4.497	10.319	3.333	0.915	0.579
<i>POLCON</i>	0.541	1.000	0.425	0.000		<b>(0.049)</b>
<i>FAMILY</i>	0.190	0.000	0.153	0.000	0.100	0.284
<b>Panel C: Independent Corporate Governance Variables</b>						
<i>INT_AUDIT</i>	0.490	0.000	0.502	1.000		(0.913)
<i>AUDCOM</i>	0.803	0.750	0.804	0.750	0.914	0.795
<i>BOD_EXPERT</i>	0.266	0.222	0.273	0.250	0.617	0.725
<b>Panel D: Independent Control Variables</b>						
<i>TOTAL_ASSETS ('000)</i>	9360000	2890000	13800000	2500000	0.393	0.637
<i>ASSETS</i>	19.728	19.483	19.651	19.434	0.635	0.637
<i>DEBT_EQUITY</i>	0.932	0.623	0.835	0.603	0.372	0.263
<i>NEG_EQUITY</i>	0.020	0.000	0.034	0.000		(0.639)
<i>LOSS</i>	0.235	0.000	0.168	0.000		(0.279)
<i>BIG_4</i>	0.704	1.000	0.685	1.000		(0.766)

T-test of mean difference; Mann-Whitney is test of median difference.

Restate takes the value of 1 if the firm restates the financial statements, zero otherwise. NAF\_RM is non-audit fees. AF\_RM is audit fees while TF\_RM is total fees. TAX\_RM, AUDREL\_RM and OTHERS\_RM are tax-related, audit related and other services non-audit fees respectively. NAF\_REC\_RM and NAF\_NREC\_RM are recurring and non-recurring non-audit fees respectively. TAX\_REC\_RM and TAX\_NREC\_RM are recurring and non-recurring tax-related non-audit fees respectively. AUDREL\_REC\_RM and AUDREL\_NREC\_RM are recurring and non-recurring audit related non-audit fees respectively. OTHERS\_REC\_RM and OTHERS\_NREC\_RM are recurring and non-recurring other services non-audit fees, respectively. TAX, AUDREL and OTHERS are tax-related, audit-related and other services non-audit fees deflated by total fees. NAF\_REC and NAF\_NREC are recurring and non-recurring non-audit fees deflated by total fees respectively. TAX\_REC and TAX\_NREC are recurring and non-recurring tax-related non-audit fees deflated by total fees, respectively. AUDREL\_REC and AUDREL\_NREC are recurring and non-recurring audit-related non-audit fees deflated by total fees, respectively. OTHERS\_REC and OTHERS\_NREC are recurring and non-recurring other services non-audit fees deflated by total fees, respectively. BUMI is proportion of Bumiputras directors on the board. INSTOWN is percentage of ownership by top 5 institutional investors. POLCON is an indicator variable that takes the value of 1 if the firm is politically connected, zero otherwise. FAMILY is the proportion of family members on the board of directors. . INT\_AUDIT is an indicator variable that takes the value of 1 if the firm outsources its internal audit function, zero otherwise. AUDCOM is proportion of independent directors on audit committee. BOD\_EXPERT is the proportion of finance and accounting expertise on the board of directors. ASSETS is the natural log transformation of TOTAL\_ASSETS. DEBT\_EQUITY is total debt deflated by total equity. NEG\_EQUITY is an indicator variable that takes the value of 1 if the firm records a negative equity, zero otherwise. LOSS is an indicator variable that takes the value of 1 if the firm records a loss during the year, zero otherwise. BIG\_4 takes on the value of 1 if the firm is audited by a BIG 4 auditing firm, zero otherwise. Significant p-values are bold.  $X^2$  results are in parenthesis.

Table 5: Differences in Mean and Median of Variables for Different Types of Financial Restatements (2007-2009, n=953)

	Restate AR Mean	(n=30) Median	Restate M Mean	(n=51) Median	Restate I Mean	(n=17) Median	Anova p-value	Kruskal Wallis p-value
<i>Panel A: Independent Test Variables</i>								
<i>NAF_RM</i>	52560.500	16000.000	81246.275	22000.000	56206.353	14500.000	0.621	0.444
<i>AF_RM</i>	270711.367	123050.000	199812.627	117881.000	254754.824	149000.000	0.829	0.653
<i>TF_RM</i>	323271.867	149040.000	281058.902	138200.000	310961.176	178300.000	0.658	0.705
<i>TAX_RM</i>	1769.333	0.000	2986.529	0.000	12106.353	0.000	0.806	0.699
<i>AUDREL_RM</i>	12694.100	0.000	60882.980	0.000	6764.706	0.000	0.877	0.110
<i>OTHERS_RM</i>	38097.067	6000.000	17376.765	4000.000	37335.294	10500.000	0.866	0.266
<i>NAF_REC_RM</i>	45360.500	9000.000	74609.863	10250.000	16370.588	10000.000	0.757	0.572
<i>NAF_NREC_RM</i>	7200.000	0.000	6636.412	0.000	39835.765	0.000	0.720	0.140
<i>TAX_REC_RM</i>	1769.333	0.000	2813.490	0.000	0.000	0.000	0.822	0.511
<i>TAX_NREC_RM</i>	0.000	0.000	173.039	0.000	12106.353	0.000	0.871	<b>0.051</b>
<i>AUDREL_REC_RM</i>	5960.767	0.000	56322.549	0.000	6764.706	0.000	0.789	0.619
<i>AUDREL_NREC_RM</i>	6733.333	0.000	4560.431	0.000	0.000	0.000	0.877	0.293
<i>OTHERS_REC_RM</i>	37630.400	4000.000	15473.824	0.000	9605.882	8000.000	0.902	<b>0.078</b>
<i>OTHERS_NREC_RM</i>	466.667	0.000	1902.941	0.000	27729.412	0.000	0.308	0.250
<i>TAX</i>	0.011	0.000	0.016	0.000	0.018	0.000	0.610	0.731
<i>AUDREL</i>	0.050	0.000	0.075	0.000	0.021	0.000	0.269	<b>0.097</b>
<i>OTHERS</i>	0.110	0.059	0.094	0.037	0.120	0.089	0.913	0.393
<i>NAF_REC</i>	0.145	0.101	0.144	0.086	0.067	0.045	0.289	0.327
<i>NAF_NREC</i>	0.026	0.000	0.041	0.000	0.093	0.000	0.178	0.135
<i>TAX_REC</i>	0.011	0.000	0.012	0.000	0.000	0.000	0.617	0.523
<i>TAX_NREC</i>	0.000	0.000	0.003	0.000	0.018	0.000	0.668	<b>0.054</b>
<i>AUDREL_REC</i>	0.027	0.000	0.051	0.000	0.021	0.000	0.543	0.608
<i>AUDREL_NREC</i>	0.023	0.000	0.023	0.000	0.000	0.000	0.627	0.285
<i>OTHERS_REC</i>	0.107	0.044	0.080	0.000	0.046	0.031	0.539	<b>0.084</b>
<i>OTHERS_NREC</i>	0.003	0.000	0.014	0.000	0.074	0.000	0.104	0.238

	Restate AR Mean	(n=30) Median	Restate M Mean	(n=51) Median	Restate I Mean	(n=17) Median	Anova p-value	Kruskal Wallis p-value
<b>Panel B: Independent Institutional Variables</b>								
<i>BUMI</i>	0.412	0.429	0.433	0.417	0.375	0.400	0.587	0.750
<i>INSTOWN</i>	7.764	1.557	10.487	3.296	14.183	14.731	0.539	0.159
<i>POLCON</i>	0.433	0.000	0.627	1.000	0.471	0.000		<b>(0.098)</b>
<i>FAMILY</i>	0.194	0.000	0.180	0.000	0.213	0.000	0.393	0.760
<b>Panel C: Independent Corporate Governance Variables</b>								
<i>INT_AUDIT</i>	0.600	1.000	0.490	0.000	0.294	0.000		(0.383)
<i>AUDCOM</i>	0.822	0.750	0.786	0.667	0.819	0.750	0.748	0.601
<i>BOD_EXPERT</i>	0.241	0.222	0.280	0.250	0.269	0.222	0.667	0.811
<b>Panel D: Independent Control Variables</b>								
<i>TOTAL_ASSETS('000)</i>	9303000	2899000	7664000	2571000	14570000	3720000	0.805	0.768
<i>ASSETS</i>	19.791	19.485	19.579	19.365	20.064	19.734	0.636	0.768
<i>DEBT_EQUITY</i>	0.849	0.522	0.995	0.689	0.885	1.065	0.788	0.443
<i>NEG_EQUITY</i>	0.000	0.000	0.000	0.000	0.118	0.000		(0.109)
<i>LOSS</i>	0.200	0.000	0.255	0.000	0.235	0.000		(0.376)
<i>BIG_4</i>	0.700	1.000	0.686	1.000	0.765	1.000		(0.955)

Anova test of differences among means; Kruskal Wallis test of differences among medians.

Restate\_AR is restatements due to accounting rules application failure; Restate\_I is restatements due to accounting irregularities; and Restate\_M is restatements due to misrepresentations. NAF\_RM is non-audit fees. AF\_RM is audit fees while TF\_RM is total fees. TAX\_RM, AUDREL\_RM and OTHERS\_RM are tax-related, audit related and other services non-audit fees, respectively. NAF\_REC\_RM and NAF\_NREC\_RM are recurring and non-recurring non-audit fees, respectively. TAX\_REC\_RM and TAX\_NREC\_RM are recurring and non-recurring tax-related non-audit fees, respectively. AUDREL\_REC\_RM and AUDREL\_NREC\_RM are recurring and non-recurring audit related non-audit fees, respectively. OTHERS\_REC\_RM and OTHERS\_NREC\_RM are recurring and non-recurring other services non-audit fees, respectively. TAX, AUDREL and OTHERS are tax-related, audit-related and other services non-audit fees deflated by total fees. NAF\_REC and NAF\_NREC are recurring and non-recurring non-audit fees deflated by total fees respectively. TAX\_REC and TAX\_NREC are recurring and non-recurring tax-related non-audit fees deflated by total fees, respectively. AUDREL\_REC and AUDREL\_NREC are recurring and non-recurring audit-related non-audit fees deflated by total fees, respectively. OTHERS\_REC and OTHERS\_NREC are recurring and non-recurring other services non-audit fees deflated by total fees, respectively. BUMI is proportion of Bumiputras directors on the board. INSTOWN is percentage of ownership by top 5 institutional investors. POLCON is an indicator variable that takes the value of 1 if the firm is politically connected, zero otherwise. FAMILY is the proportion of family members on the board of directors. INT\_AUDIT is an indicator variable that takes the value of 1 if the firm outsources its internal audit function, zero otherwise. AUDCOM is proportion of independent directors on audit committee. BOD\_EXPERT is the proportion of finance and accounting expertise on the board of directors. ASSETS is natural log transformation of TOTAL\_ASSETS. DEBT\_EQUITY is total debt deflated by total equity. NEG\_EQUITY is an indicator variable that takes the value of 1 if the firm records a negative equity, zero otherwise. LOSS is an indicator variable that takes the value of 1 if the firm records a loss during the year, zero otherwise. BIG\_4 takes on the value of 1 if the firm is audited by a BIG 4 auditing firm, zero otherwise. Significant p-values are bold. X<sup>2</sup> results are in parenthesis.

Table 6: Correlations Matrix (2007-2009, n=953)

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
1 <i>RESTATE</i>		-0.064 <sup>#</sup>	-0.019	-0.060 <sup>@</sup>	0.041	-0.017	0.011	0.071 <sup>#</sup>	0.036	-0.007	-0.008	-0.008	0.016	0.029	-0.023	0.053	0.012
2 <i>NAF</i>	-0.074 <sup>#</sup>		0.210 <sup>*</sup>	0.131 <sup>*</sup>	0.232 <sup>*</sup>	0.002	-0.038	0.012	-0.073 <sup>#</sup>	-0.019	-0.032	0.066 <sup>#</sup>	0.078 <sup>#</sup>	-0.01	-0.003	-0.027	0.116 <sup>*</sup>
3 <i>TAX</i>	-0.04	0.324 <sup>*</sup>		-0.229 <sup>*</sup>	-0.298 <sup>*</sup>	-0.064	0.132 <sup>*</sup>	0.112 <sup>*</sup>	-0.077 <sup>#</sup>	-0.046	-0.030	0.077 <sup>#</sup>	0.101 <sup>*</sup>	-0.004	-0.012	-0.043	0.058 <sup>@</sup>
4 <i>AUDREL</i>	-0.049	0.421 <sup>*</sup>	-0.137 <sup>*</sup>		-0.737 <sup>*</sup>	0.075 <sup>#</sup>	-0.138 <sup>*</sup>	-0.002	-0.019	0.028	0.071 <sup>#</sup>	-0.074 <sup>#</sup>	-0.074 <sup>#</sup>	-0.027	-0.011	-0.007	-0.241 <sup>*</sup>
5 <i>OTHERS</i>	-0.011	0.514 <sup>*</sup>	-0.171 <sup>*</sup>	-0.352 <sup>*</sup>		-0.026	0.028	-0.065 <sup>#</sup>	0.036	-0.002	-0.065 <sup>#</sup>	0.048	0.039	0.02	0.018	0.019	0.237 <sup>*</sup>
6 <i>BUMI</i>	-0.012	0.012	-0.037	0.015	0.024		0.028	0.091 <sup>*</sup>	-0.123 <sup>*</sup>	0.006	-0.066 <sup>#</sup>	0.028	-0.003	-0.052	0.043	-0.028	-0.052
7 <i>INSTOWN</i>	-0.001	0.017	0.087 <sup>*</sup>	-0.026	-0.014	0.043		0.108 <sup>*</sup>	0.095 <sup>*</sup>	-0.202 <sup>*</sup>	-0.016	0.048	0.189 <sup>*</sup>	0.009	0.046	-0.073 <sup>#</sup>	0.192 <sup>*</sup>
8 <i>POLCON</i>	0.071 <sup>#</sup>	0.025	0.096 <sup>*</sup>	0.008	-0.042	0.152 <sup>*</sup>	0.148 <sup>*</sup>		-0.083 <sup>*</sup>	-0.174 <sup>*</sup>	-0.034	0.022	0.174 <sup>*</sup>	0.039	0.041	-0.055 <sup>@</sup>	-0.05
9 <i>FAMILY</i>	0.049	-0.099 <sup>*</sup>	-0.083 <sup>#</sup>	-0.071	0.008	-0.132 <sup>*</sup>	0.037	-0.079 <sup>#</sup>		0.021	-0.026	-0.080 <sup>#</sup>	-0.076	-0.01	-0.023	0.007	0.005
10 <i>INT_AUDIT</i>	-0.007	-0.042	-0.074 <sup>#</sup>	0.004	-0.002	-0.044	-0.173 <sup>*</sup>	-0.174 <sup>*</sup>	0.017		-0.05	-0.06	-0.347 <sup>*</sup>	-0.104 <sup>*</sup>	-0.042	0.085 <sup>*</sup>	-0.131 <sup>*</sup>
11 <i>AUDCOM</i>	-0.003	-0.023	-0.005	0.033	-0.051	-0.077 <sup>#</sup>	-0.029	-0.05	-0.011	-0.03		0.04	0.076 <sup>#</sup>	0.012	0.011	0.025	0.018
12 <i>BOD_EXPERT</i>	-0.014	0.100 <sup>*</sup>	0.158 <sup>*</sup>	-0.02	0.026	-0.012	0.042	0.02	-0.056 <sup>@</sup>	-0.058	0.034		0.025	0.089 <sup>*</sup>	0.006	0.054 <sup>@</sup>	0.041
13 <i>ASSETS</i>	0.016	0.114 <sup>*</sup>	0.140 <sup>*</sup>	-0.011	0.045	0.039	0.220 <sup>*</sup>	0.171 <sup>*</sup>	-0.070 <sup>#</sup>	-0.315 <sup>*</sup>	0.048	0.033		0.249 <sup>*</sup>	-0.159 <sup>*</sup>	-0.225 <sup>*</sup>	0.270 <sup>*</sup>
14 <i>DEBT_EQUITY</i>	0.022	0.022	0.041	0.016	-0.018	-0.038	-0.018	0.016	-0.021	-0.104 <sup>*</sup>	-0.002	0.076	0.238 <sup>*</sup>		-0.307 <sup>*</sup>	0.126 <sup>*</sup>	0.046
15 <i>NEG_EQUITY</i>	-0.023	-0.001	-0.009	0.009	-0.003	0.054	0.021	0.041	-0.019	-0.042	-0.001	-0.001	-0.218 <sup>*</sup>	-0.497 <sup>*</sup>		0.071 <sup>#</sup>	-0.017
16 <i>LOSS</i>	0.053	-0.015	-0.035	0.014	-0.005	-0.068	-0.073	-0.055	0.024	0.085 <sup>*</sup>	0.036	0.057	-0.193 <sup>*</sup>	0.088 <sup>*</sup>	0.071 <sup>#</sup>		-0.100 <sup>*</sup>
17 <i>BIG_4</i>	0.012	0.105 <sup>*</sup>	0.097 <sup>*</sup>	-0.148 <sup>*</sup>	0.187 <sup>*</sup>	-0.002	0.153 <sup>**</sup>	-0.05	0.004	-0.131 <sup>*</sup>	0.008	0.05	0.223 <sup>*</sup>	0.018	-0.017	-0.100 <sup>*</sup>	

Spearman-rank correlations are in the upper half of diagonal; Pearson correlations are in the lower half.

RESTATE takes the value of 1 if the firm restates the financial statements, zero otherwise. NAF is non-audit fees deflated by total fees. TAX, AUDREL and OTHERS are tax-related, audit-related and other services non-audit fees deflated by total fees, respectively. BUMI is proportion of Bumiputra directors on the board. INSTOWN is percentage ownership by top 5 institutional investors. POLCON is an indicator variable that takes the value of 1 if the firm is politically connected, zero otherwise. FAMILY is the proportion of family members on the board of directors. INT\_AUDIT is an indicator variable that takes the value of 1 if the firm outsources its internal audit function, zero otherwise. AUDCOM is proportion of independent directors on audit committee. BOD\_EXPERT is the proportion of finance and accounting expertise on the board of directors. ASSETS is natural log transformation of total assets. DEBT\_EQUITY is total debt deflated by total equity. NEG\_EQUITY is an indicator variable that takes the value of 1 if the firm records a negative equity, zero otherwise. LOSS is an indicator variable that takes the value of 1 if the firm records a loss during the year, zero otherwise. BIG\_4 takes on the value of 1 if the firm is audited by a BIG 4 auditing firm, zero otherwise. @, # and \* denote significant levels of 10%, 5% and 1% based on two-tailed test, respectively.

**Table 7: Univariate Analyses of Variables among Different Types of NAS (2007-2009, n=953)**

	(TAX Mean	(n=81) Median	(AUDREL Mean	(n=361) Median	(OTHERS Mean	(n=511) Median	Anova P- value	Kruskal Wallis p-value
<b>Panel A :Independent Test Variables</b>								
RESTATE	0.086	0.000	0.080	0.000	0.121	0.000		<b>(0.000)</b>
NAF_RM	637121.679	80770.000	134689.587	22000.000	104661.400	20000.000	<b>0.000</b>	<b>0.000</b>
AF_RM	647164.593	178475.000	235600.662	118000.000	328871.500	113000.000	<b>0.004</b>	<b>0.000</b>
TF_RM	1284286.272	272054.000	370290.249	153219.000	433532.900	152500.000	<b>0.000</b>	<b>0.000</b>
NAF_REC_RM	588568.765	51634.000	70655.374	8000.000	86338.630	10000.000	<b>0.000</b>	<b>0.000</b>
NAF_NREC_RM	48552.914	0.000	64034.213	0.000	18322.770	0.000	<b>0.034</b>	0.177
NAF_REC	0.247	0.242	0.129	0.061	0.144	0.077	<b>0.000</b>	<b>0.000</b>
NAF_NREC	0.078	0.000	0.079	0.000	0.059	0.000	0.194	0.171
<b>Panel B: Independent Institutional Variables</b>								
BUMI	0.394	0.400	0.430	0.429	0.421	0.400	0.181	<b>0.022</b>
INSTOWN	16.138	12.840	7.928	2.087	11.080	4.762	<b>0.000</b>	<b>0.000</b>
POLCON	0.617	1.000	0.438	0.000	0.407	0.000		<b>(0.000)</b>
FAMILY	0.103	0.000	0.153	0.000	0.169	0.000	<b>0.042</b>	0.112
<b>Panel C: Independent Corporate Governance Variables</b>								
INT_AUDIT	0.432	0.000	0.515	1.000	0.501	1.000		<b>(0.000)</b>
AUDCOM	0.783	0.750	0.822	<b>0.750</b>	0.795	0.750	<b>0.016</b>	<b>0.031</b>
BOD_EXPERT	0.314	0.250	0.257	0.222	0.276	0.250	<b>0.004</b>	<b>0.007</b>
<b>Panel D: Independent Control Variables</b>								
TOTAL_ASSETS('000)	3528000	539500	1288000	250100	1020000	281000	<b>0.000</b>	<b>0.001</b>
ASSETS	20.279	20.106	19.524	19.337	19.656	19.453	<b>0.000</b>	<b>0.001</b>
DEBT_EQUITY	0.919	0.504	0.912	0.557	0.786	0.637	0.309	0.748
NEG_EQUITY	0.025	0.000	0.030	0.000	0.035	0.000		<b>(0.000)</b>
LOSS	0.123	0.000	0.169	0.000	0.188	0.000		<b>(0.000)</b>
BIG_4	0.765	1.000	0.529	1.000	0.787	1.000		<b>(0.000)</b>

Anova test of differences among means; Kruskal Wallis test of differences among medians.

TAX, AUDREL and OTHERS are tax-related, audit-related and other services non-audit fees deflated by total fees, respectively RESTATE takes the value of 1 if the firm restates the financial statements, zero otherwise. NAF\_RM is non-audit fees. AF\_RM is audit fees while TF\_RM is total fees.. NAF\_REC\_RM and NAF\_NREC\_RM are recurring and non-recurring non-audit fees, respectively. NAF\_REC and NAF\_NREC are recurring and non-recurring non-audit fees deflated by total fees, respectively. BUMI is proportion of Bumiputras directors on the board. INSTOWN is percentage ownership by top 5 institutional investors. POLCON is an indicator variable that takes the value of 1 if the firm is politically connected, zero otherwise. FAMILY is the proportion of family members on the board of directors. INT\_AUDIT is an indicator variable that takes the value of 1 if the firm outsources its internal audit function, zero otherwise. AUDCOM is proportion of independent directors on audit committee. BOD\_EXPERT is the proportion of finance and accounting expertise on the board of directors. ASSETS is natural log transformation of TOTAL\_ASSETS. DEBT\_EQUITY is total debt deflated by total equity. NEG\_EQUITY is an indicator variable that takes the value of 1 if the firm records a negative equity, zero otherwise. LOSS is an indicator variable that takes the value of 1 if the firm records a loss during the year, zero otherwise. BIG\_4 takes the value of 1 if the firm is audited by a BIG 4 auditing firm, zero otherwise. Significant p-values are bold. X<sup>2</sup> results are in parenthesis.

**Table 8: Univariate Analysis for Recurring vs. Non-recurring Firms (2007-2009, n=953)**

	Recurring Mean	(n=669) Median	Non-recurring Mean	(n=284) Median	t-test p-value	Mann- Whitney p-value
<b>Panel A: Independent Test Variables</b>						
<i>RESTATE</i>	0.112	0.000	0.081	0.000		(0.529)
<i>NAF_RM</i>	175335.876	25000.000	128211.518	21125.000	0.112	0.400
<i>AF_RM</i>	360861.453	126300.000	225736.644	108000.000	<b>0.071</b>	<b>0.005</b>
<i>TF_RM</i>	536197.329	170233.000	353948.162	144760.000	<b>0.017</b>	<b>0.023</b>
<i>TAX_RM</i>	71261.689	0.000	13847.838	0.000	<b>0.015</b>	0.560
<i>AUDREL_RM</i>	38126.442	0.000	81395.602	0.000	0.145	<b>0.032</b>
<i>OTHERS_RM</i>	65947.744	4000.000	32968.077	0.000	<b>0.075</b>	<b>0.049</b>
<i>TAX</i>	0.030	0.000	0.022	0.000	0.242	0.569
<i>AUDREL</i>	0.070	0.000	0.101	0.000	0.145	<b>0.013</b>
<i>OTHERS</i>	0.110	0.029	0.106	0.000	<b>0.075</b>	0.158
<b>Panel B: Independent Institutional Variables</b>						
<i>BUMI</i>	0.420	0.417	0.427	0.429	0.430	<b>0.071</b>
<i>INSTOWN</i>	9.898	2.738	11.300	5.607	0.180	<b>0.005</b>
<i>POLCON</i>	0.436	0.000	0.437	0.000		(0.970)
<i>FAMILY</i>	0.152	0.000	0.169	0.000	0.296	0.170
<b>Panel C: Independent Corporate Governance Variables</b>						
<i>INT_AUDIT</i>	0.504	1.000	0.493	0.000		(0.747)
<i>AUDCOM</i>	0.808	0.750	0.795	0.750	0.333	0.377
<i>BOD_EXPERT</i>	0.275	0.250	0.265	0.222	0.409	0.132
<b>Panel D: Independent Control Variables</b>						
<i>TOTAL_ASSETS('000)</i>	1502000	295500	940400	243100	<b>0.024</b>	0.138
<i>ASSETS</i>	19.700	19.504	19.563	19.309	0.222	0.138
<i>DEBT_EQUITY</i>	0.848	0.605	0.837	0.611	0.944	0.779
<i>NEG_EQUITY</i>	0.034	0.000	0.028	0.000	0.618	0.751
<i>LOSS</i>	0.190	0.000	0.141	0.000		<b>(0.063)</b>
<i>BIG_4</i>	0.695	1.000	0.669	1.000		(0.972)

RESTATE takes the value of 1 if the firm restates the financial statements, zero otherwise. NAF\_RM is non-audit fees. AF\_RM is audit fees while TF\_RM is total fees. TAX\_RM, AUDREL\_RM and OTHERS\_RM are tax-related, audit related and other services non-audit fees, respectively. TAX, AUDREL and OTHERS are tax-related, audit-related and other services non-audit fees deflated by total fees, respectively. BUMI is proportion of Bumiputras directors on the board. INSTOWN is percentage ownership by top 5 institutional investors. POLCON is an indicator variable that takes the value of 1 if the firm is politically connected, zero otherwise. FAMILY is the proportion of family members on the board of directors. INT\_AUDIT is an indicator variable that takes the value of 1 if the firm outsources its internal audit function, zero otherwise. AUDCOM is proportion of independent directors on audit committee. BOD\_EXPERT is the proportion of finance and accounting expertise on the board of directors. ASSETS is natural log transformation of TOTAL\_ASSETS. DEBT\_EQUITY is total debt deflated by total equity. NEG\_EQUITY is an indicator variable that takes the value of 1 if the firm records a negative equity, zero otherwise. LOSS is an indicator variable that takes the value of 1 if the firm records a loss during the year, zero otherwise. BIG\_4 takes on the value of 1 if the firm is audited by a BIG 4 auditing firm, zero otherwise. Significant p-values are bold.  $\chi^2$  results are in parenthesis.

Table 9: Main Regression Results (2007-2009, n=953)

Variable	Expected Direction	Coefficient 1	Coefficient 2
<i>INTERCEPT</i>	?	-0.401 -0.395	-0.478 -0.468
<i>NAF</i>	-	-0.713 <b>-2.051**</b>	
<i>TAX</i>	-		-1.370 <b>-1.754**</b>
<i>AUDREL</i>	-		-0.840 <b>-1.622*</b>
<i>OTHERS</i>	-		-0.441 -1.126
<i>BUMI</i>	+	-0.214 -0.573	-0.224 -0.601
<i>INSTOWN</i>	-	-0.001 -0.335	-0.001 -0.266
<i>POLCON</i>	+	0.265 <b>2.124**</b>	0.277 <b>2.218**</b>
<i>FAMILY</i>	-	0.335 1.262	0.314 1.172
<i>INT_AUDIT</i>	-	-0.054 -0.409	-0.056 -0.419
<i>AUDCOM</i>	-	-0.007 <b>-1.785**</b>	-0.007 <b>-1.746**</b>
<i>BOD_EXPERT</i>	-	-0.342 -0.809	-0.354 -0.833
<i>ASSETS</i>	+	0.019 0.413	0.023 0.501
<i>DEBT_EQUITY</i>	+	-0.009 -0.195	-0.008 -0.172
<i>NEG_EQUITY</i>	+	-0.321 -0.740	-0.320 -0.734
<i>LOSS</i>	+	0.262 <b>1.755**</b>	0.256 <b>1.710**</b>
<i>BIG_4</i>	-	0.105 0.782	0.086 0.619
<i>Period and Industry Dummies</i>		Included	Included
<i>McFadden R<sup>2</sup></i>		0.133	0.136
<i>LR statistic</i>		<b>84.160***</b>	<b>85.702***</b>
Obs with Dep=0		855	855
Obs with Dep=1		98	98

First value in table is coefficient and second value is z-statistic.

Dep is RESTATE dependent variable which takes the value of 1 if the firm restates the financial statements, zero otherwise. NAF is non-audit fees deflated by total fees. TAX, AUDREL and OTHERS are tax-related, audit-related and other services non-audit fees deflated by total fees, respectively. BUMI is proportion of Bumiputra directors on the board. INSTOWN is percentage ownership by top 5 institutional investors. POLCON is an indicator variable that takes the value of 1 if the firm is politically connected, zero otherwise. FAMILY is the proportion of family members on the board of directors. INT\_AUDIT is an indicator variable that takes the value of 1 if the firm outsources its internal audit function, zero otherwise. AUDCOM is proportion of independent directors on audit committee. BOD\_EXPERT is the proportion of finance and accounting expertise on the board of directors. ASSETS is natural log transformation of total assets. DEBT\_EQUITY is total debt deflated by total equity. NEG\_EQUITY is an indicator variable that takes the value of 1 if the firm records a negative equity, zero otherwise. LOSS is an indicator variable that takes the value of 1 if the firm records a loss during the year, zero otherwise. BIG\_4 takes on the value of 1 if the firm is audited by a BIG 4 auditing firm, zero otherwise. \*, \*\* and \*\*\* denote significant levels of 10%, 5% and 1% based on one-tailed test, respectively.

**Table 10: Regressions on Types of Recurring and Non-recurring NAS (2007-2009, n=953)**

Variable	Expected Direction	Coefficient 1	Coefficient 2	Coefficient 3	Coefficient 4	Coefficient 5
<i>INTERCEPT</i>	?	-0.403	-0.473	-0.430	-0.387	-0.521
		-0.396	-0.468	-0.430	-0.391	-0.510
<i>NAF_REC</i>	-	-0.755				
		<b>-1.933**</b>				
<i>NAF_NREC</i>	-	-0.625				
		-1.279				
<i>TAX_REC</i>	-		-1.443			-1.779
			<b>-1.453*</b>			<b>-1.674**</b>
<i>TAX_NREC</i>	-		0.155			-0.175
			0.172			-0.189
<i>AUDREL_REC</i>	-			-0.674		-0.957
				-1.126		<b>-1.512*</b>
<i>AUDREL_NREC</i>	-			-0.388		-0.649
				-0.559		-0.876
<i>OTHERS_REC</i>	-				0.067	-0.357
					0.173	-0.804
<i>OTHERS_NREC</i>	-				-0.252	-0.646
					-0.433	-1.043
<i>BUMI</i>	+	-0.210	-0.209	-0.199	-0.210	-0.219
		-0.563	-0.554	-0.535	-0.560	-0.590
<i>INSTOWN</i>	-	-0.001	-0.001	-0.001	-0.001	-0.001
		-0.343	-0.143	-0.327	-0.227	-0.332
<i>POLCON</i>	+	0.264	0.272	0.261	0.261	0.281
		<b>2.115**</b>	<b>2.170**</b>	<b>2.101**</b>	<b>2.093**</b>	<b>2.259**</b>
<i>FAMILY</i>	-	0.336	0.335	0.319	0.342	0.309
		<b>1.264*</b>	1.258	1.201	<b>1.286*</b>	1.157
<i>INT_AUDIT</i>	-	-0.055	-0.061	-0.053	-0.057	-0.058
		-0.414	-0.457	-0.402	-0.427	-0.437
<i>AUDCOM</i>	-	-0.007	-0.006	-0.006	-0.006	-0.007
		<b>-1.785**</b>	<b>-1.640**</b>	<b>-1.615*</b>	<b>-1.645**</b>	<b>-1.673**</b>
<i>BOD_EXPERT</i>	-	-0.340	-0.376	-0.447	-0.426	-0.350
		-0.806	-0.879	-1.060	-1.010	-0.822
<i>ASSETS</i>	+	0.019	0.016	0.016	0.011	0.025
		0.416	0.357	0.343	0.245	0.530
<i>DEBT_EQUITY</i>	+	-0.009	-0.011	-0.008	-0.010	-0.009
		-0.190	-0.238	-0.178	-0.215	-0.201
<i>NEG_EQUITY</i>	+	-0.322	-0.336	-0.316	-0.314	-0.326
		-0.743	-0.768	-0.722	-0.723	-0.743
<i>LOSS</i>	+	0.263	0.259	0.252	0.256	0.258
		<b>1.757**</b>	<b>1.738**</b>	<b>1.687**</b>	<b>1.719**</b>	<b>1.720**</b>
<i>BIG_4</i>	-	0.107	0.087	0.051	0.073	0.083
		0.802	0.637	0.366	0.531	0.598
<i>Period and Industry Dummies</i>		Included	Included	Included	Included	Included
<i>McFadden R<sup>2</sup></i>		0.133	0.132	0.130	0.128	0.138
<i>LR statistic</i>		<b>84.221***</b>	<b>83.469***</b>	<b>82.177***</b>	<b>80.639***</b>	<b>86.884***</b>
Obs with Dep=0		855	855	855	855	855
Obs with Dep=1		98	98	98	98	98

First value in table is coefficient and second value is z-statistic.

Dep is RESTATE dependent variable which takes the value of 1 if the firm restates the financial statements, zero otherwise. NAF\_REC and NAF\_NREC are recurring and non-recurring non-audit fees deflated by total fees, respectively. TAX\_REC and TAX\_NREC are recurring and non-recurring tax-related non-audit fees deflated by total fees, respectively. AUDREL\_REC and AUDREL\_NREC are recurring and non-recurring audit-related non-audit fees deflated by total fees, respectively. OTHERS\_REC and OTHERS\_NREC are recurring and non-recurring other services non-audit fees deflated by total fees, respectively. BUMI is proportion of Bumiputra directors on the board. INSTOWN is percentage ownership by top 5 institutional investors. POLCON is an indicator variable that takes the value of 1 if the firm is politically connected, zero otherwise. FAMILY is the proportion of family members on the board of directors. INT\_AUDIT is an indicator variable that takes the value of 1 if the firm outsources its internal audit function, zero otherwise. AUDCOM is proportion of independent directors on audit committee. BOD\_EXPERT is the proportion of finance and accounting expertise on the board of directors. ASSETS is natural log transformation of total assets. DEBT\_EQUITY is total debt deflated by total equity. NEG\_EQUITY is an indicator variable that takes the value of 1 if the firm records a negative equity, zero otherwise. LOSS is an indicator variable that takes the value of 1 if the firm records a loss during the year, zero otherwise. BIG\_4 takes on the value of 1 if the firm is audited by a BIG 4 auditing firm, zero otherwise. \*, \*\*, and \*\*\* denote significant levels of 10%, 5% and 1% based on one-tailed test respectively.

**Table 11: Regressions – Politically Connected Firms vs. Non-Politically Connected Firms (2007-2009, n-953)**

Dependent Variable=RESTATE (1, 0)

Variable	Expected Direction	Coefficient	Coefficient	Coefficient	Coefficient	Coefficient	Coefficient	Coefficient	Coefficient
		Polcon=1 1	Polcon=0 2	Polcon=1 3	Polcon=0 4	Polcon=1 5	Polcon=0 6	Polcon=1 7	Polcon=0 8
<i>INTERCEPT</i>	?	-0.626	0.503	-0.639	0.588	-0.713	0.428	-0.609	0.769
		-0.498	0.255	-0.499	0.275	-0.557	0.220	-0.465	0.395
<i>NAF</i>	-	-0.630	-0.933						
		<b>-1.364*</b>	<b>-1.750**</b>						
<i>TAX</i>	-			-1.615	-0.931				
				<b>-1.531*</b>	-0.923				
<i>AUDREL</i>	-			-0.319	-1.960				
				-0.513	<b>-1.692*</b>				
<i>OTHERS</i>	-			-0.626	-0.446				
				-1.161	-0.809				
<i>NAF_REC</i>	-					-0.815	-0.825		
						<b>-1.489*</b>	<b>-1.553*</b>		
<i>NAF_NREC</i>	-					-0.346	-1.267		
						-0.596	-1.228		
<i>TAX_REC</i>	-							-2.031	-1.457
								<b>-1.448*</b>	-1.053
<i>TAX_NREC</i>	-							-0.507	0.650
								-0.470	0.340
<i>AUDREL_REC</i>	-							-0.187	-2.985
								-0.239	<b>-2.662**</b>
<i>AUDREL_NREC</i>	-							-0.570	-1.050
								-0.644	-0.744
<i>OTHERS_REC</i>	-							-0.960	-0.180
								<b>-1.524*</b>	-0.316
<i>OTHERS_NREC</i>	-							-0.181	-2.488
								-0.246	<b>-2.100**</b>
<i>BUMI</i>	+	-0.084	-0.410	-0.062	-0.389	-0.048	-0.399	0.012	-0.391
		-0.192	-0.627	-0.140	-0.602	-0.109	-0.609	0.027	-0.602
<i>INSTOWN</i>	-	-0.009	0.007	-0.008	0.006	-0.009	0.007	-0.008	0.004
		<b>-1.374*</b>	1.163	<b>-1.308*</b>	1.003	<b>-1.403*</b>	1.174	-1.214	0.723
<i>FAMILY</i>	-	0.417	0.299	0.405	0.224	0.420	0.294	0.411	0.177
		1.103	0.795	1.064	0.592	1.112	0.786	1.076	0.455

		1	2	3	4	5	6	7	8
<i>INT_AUDIT</i>	-	-0.097	-0.010	-0.102	-0.018	-0.101	-0.008	-0.105	-0.045
		<i>-0.482</i>	<i>-0.055</i>	<i>-0.504</i>	<i>-0.095</i>	<i>-0.498</i>	<i>-0.043</i>	<i>-0.515</i>	<i>-0.243</i>
<i>AUDCOM</i>	-	-0.011	-0.006	-0.011	-0.006	-0.010	-0.006	-0.011	-0.005
		<b>-1.765**</b>	<i>-1.127</i>	<b>-1.788**</b>	<i>-1.046</i>	<b>-1.726**</b>	<i>-1.086</i>	<b>-1.786**</b>	<i>-0.879</i>
<i>BOD_EXPERT</i>	-	-0.435	-0.413	-0.422	-0.528	-0.429	-0.417	-0.414	-0.585
		<i>-0.777</i>	<i>-0.666</i>	<i>-0.756</i>	<i>-0.816</i>	<i>-0.772</i>	<i>-0.674</i>	<i>-0.746</i>	<i>-0.914</i>
<i>ASSETS</i>	+	0.062	-0.028	0.064	-0.030	0.065	-0.025	0.062	-0.038
		<i>1.155</i>	<i>-0.290</i>	<i>1.158</i>	<i>-0.296</i>	<i>1.192</i>	<i>-0.267</i>	<i>1.104</i>	<i>-0.405</i>
<i>DEBT_EQUITY</i>	+	-0.027	0.014	-0.027	0.012	-0.027	0.013	-0.037	0.014
		<i>-0.421</i>	<i>0.223</i>	<i>-0.416</i>	<i>0.190</i>	<i>-0.417</i>	<i>0.207</i>	<i>-0.577</i>	<i>0.209</i>
<i>NEG_EQUITY</i>	+	-0.531	0.067	-0.523	0.037	-0.532	0.081	-0.592	0.197
		<i>-0.835</i>	<i>0.114</i>	<i>-0.818</i>	<i>0.063</i>	<i>-0.832</i>	<i>0.140</i>	<i>-0.924</i>	<i>0.339</i>
<i>LOSS</i>	+	0.357	0.154	0.359	0.152	0.365	0.154	0.376	0.144
		<b>1.653*</b>	<i>0.741</i>	<b>1.678**</b>	<i>0.711</i>	<b>1.697**</b>	<i>0.743</i>	<b>1.755**</b>	<i>0.662</i>
<i>BIG_4</i>	-	0.178	-0.002	0.202	-0.056	0.182	-0.009	0.211	-0.088
		<i>0.906</i>	<i>-0.008</i>	<i>0.981</i>	<i>-0.281</i>	<i>0.928</i>	<i>-0.049</i>	<i>1.014</i>	<i>-0.440</i>
<i>Period and Industry Dummies</i>		Included							
<i>McFadden R<sup>2</sup></i>		0.148	0.135	0.153	0.146	0.150	0.136	0.157	0.160
<i>LR statistic</i>		<b>47.115***</b>	<b>41.853***</b>	<b>48.657***</b>	<b>45.014***</b>	<b>47.566***</b>	<b>42.103***</b>	<b>49.868***</b>	<b>49.552***</b>
Obs with Dep=0		363	492	363	492	363	492	363	492
Obs with Dep=1		53	45	53	45	53	45	53	45

First value in table is variable coefficient and second value is z-statistic.

RESTATE takes the value of 1 if the firm restates the financial statements, zero otherwise. Polcon is an indicator variable that takes the value of 1 if the firm is politically connected, zero otherwise. NAF is non-audit fees deflated by total fees. TAX, AUDREL and OTHERS are tax-related, audit-related and other services non-audit fees deflated by total fees, respectively. NAF\_REC and NAF\_NREC are recurring and non-recurring non-audit fees deflated by total fees, respectively. TAX\_REC and TAX\_NREC are recurring and non-recurring tax-related non-audit fees deflated by total fees, respectively. AUDREL\_REC and AUDREL\_NREC are recurring and non-recurring audit-related non-audit fees deflated by total fees, respectively. OTHERS\_REC and OTHERS\_NREC are recurring and non-recurring other services non-audit fees deflated by total fees, respectively. . BUMI is proportion of Bumiputra directors on the board. INSTOWN is percentage ownership by top 5 institutional investors. FAMILY is the proportion of family members on the board of directors. INT\_AUDIT is an indicator variable that takes the value of 1 if the firm outsources its internal audit function, zero otherwise. AUDCOM is proportion of independent directors on audit committee. BOD\_EXPERT is the proportion of finance and accounting expertise on the board of directors. ASSETS is natural log transformation of total assets. DEBT\_EQUITY is total debt deflated by total equity. NEG\_EQUITY is an indicator variable that takes the value of 1 if the firm records a negative equity, zero otherwise. LOSS is an indicator variable that takes the value of 1 if the firm records a loss during the year, zero otherwise. BIG\_4 takes on the value of 1 if the firm is audited by a BIG 4 auditing firm, zero otherwise. \*, \*\*, and \*\*\* denote significant levels of 10%, 5% and 1% based on one-tailed test, respectively.

**Appendix A: Differences in Variables Mean and Median between Politically and non-Politically Connected Firms (2007-2009, n=953)**

	(Polcon=1 Mean	n=416 Median	(Polcon=0 Mean	n=537 Median	t-test p-value	Mann-Whitney p-value
<i>Panel A: Test Variables</i>						
RESTATE	0.127	0.000	0.084	0.000		<b>(0.014)</b>
NAF_RM	223836.382	25700.000	112841.410	23000.000	0.201	<b>0.030</b>
AF_RM	478330.474	137500.000	198398.588	112000.000	<b>0.000</b>	<b>0.000</b>
TF_RM	702166.856	186300.000	311239.998	145309.000	<b>0.003</b>	<b>0.000</b>
TAX_RM	52601.846	0.000	55352.864	0.000	0.360	<b>0.001</b>
AUDREL_RM	88095.450	0.000	22300.250	0.000	<b>0.009</b>	0.631
OTHERS_RM	83139.087	300.000	35188.296	4000.000	<b>0.079</b>	<b>0.074</b>
NAF_REC_RM	166208.803	10000.000	89677.540	10000.000	0.494	0.220
NAF_NREC_RM	57627.579	0.000	23163.870	0.000	<b>0.053</b>	0.868
TAX_REC_RM	44122.200	0.000	54598.203	0.000	0.258	<b>0.004</b>
TAX_NREC_RM	8479.647	0.000	754.661	0.000	<b>0.042</b>	<b>0.078</b>
AUDREL_REC_RM	48235.067	0.000	10131.847	0.000	<b>0.037</b>	0.600
AUDREL_NREC_RM	39860.382	0.000	12168.402	0.000	0.115	0.853
OTHERS_REC_RM	73851.536	0.000	24947.490	0.000	<b>0.069</b>	0.153
OTHERS_NREC_RM	9287.550	0.000	10240.806	0.000	0.683	0.541
TAX	0.039	0.000	0.019	0.000	<b>0.013</b>	<b>0.001</b>
AUDREL	0.080	0.000	0.078	0.000	0.746	0.958
OTHERS	0.101	0.003	0.115	0.039	0.134	<b>0.031</b>
NAF_REC	0.149	0.079	0.146	0.081	0.952	0.899
NAF_NREC	0.072	0.000	0.066	0.000	0.593	0.982
TAX_REC	0.029	0.000	0.015	0.000	<b>0.093</b>	<b>0.005</b>
TAX_NREC	0.010	0.000	0.004	0.000	<b>0.044</b>	0.081
AUDREL_REC	0.050	0.000	0.048	0.000	0.855	0.770
AUDREL_NREC	0.031	0.000	0.030	0.000	0.800	0.798
OTHERS_REC	0.070	0.000	0.083	0.000	0.187	<b>0.080</b>
OTHERS_NREC	0.031	0.000	0.032	0.000	0.584	0.556
<i>Panel B: Institutional Variables</i>						
BUMI	0.449	0.429	0.401	0.429	<b>0.000</b>	<b>0.006</b>
INSTOWN	12.751	5.969	8.430	2.763	<b>0.000</b>	<b>0.000</b>
FAMILY	0.346	0.000	0.412	0.000	<b>0.024</b>	<b>0.019</b>
<i>Panel C: Corporate Governance Variables</i>						
INT_AUDIT	0.401	0.000	0.577	1.000		<b>(0.000)</b>
AUDCOM	0.795	0.750	0.811	0.750	<b>0.087</b>	0.229
BOD_EXPERT	0.275	0.250	0.269	0.250	0.667	0.663
<i>Panel C: Control Variables</i>						
TOTAL_ASSETS('000)	1992000	373600	825100	227000	<b>0.001</b>	<b>0.000</b>
ASSETS	19.944	19.739	19.439	19.240	<b>0.000</b>	<b>0.000</b>
DEBT_EQUITY	0.869	0.661	0.826	0.557	0.344	<b>0.089</b>
NEG_EQUITY	0.041	0.000	0.026	0.000		<b>(0.658)</b>
LOSS	0.151	0.000	0.194	0.000		<b>(0.088)</b>
BIG_4	0.661	1.000	0.708	1.000		<b>(0.974)</b>

T-test of mean difference; Mann-Whitney is test of median difference.

Polcon is an indicator variable that takes the value of 1 if the firm is politically connected, zero otherwise. RESTATE takes the value of 1 if the firm restates the financial statements, zero otherwise. NAF\_RM is non-audit fees. AF\_RM is audit fees while TF\_RM is total fees. TAX\_RM, AUDREL\_RM and OTHERS\_RM are tax-related, audit-related and other services non-audit fees, respectively. NAF\_REC\_RM and NAF\_NREC\_RM are recurring and non-recurring non-audit fees, respectively. TAX\_REC\_RM and TAX\_NREC\_RM are recurring and non-recurring tax-related non-audit fees, respectively. AUDREL\_REC\_RM and AUDREL\_NREC\_RM are recurring and non-recurring audit-related non-audit fees, respectively. OTHERS\_REC\_RM and OTHERS\_NREC\_RM are recurring and non-recurring other services non-audit fees, respectively. TAX, AUDREL and OTHERS are tax-related, audit-related and other services non-audit fees deflated by total fees, respectively. NAF\_REC and NAF\_NREC are recurring and non-recurring non-audit fees deflated by total fees, respectively. TAX\_REC and TAX\_NREC are recurring and non-recurring tax-related non-audit fees deflated by total fees, respectively. AUDREL\_REC and AUDREL\_NREC are recurring and non-recurring audit-related non-audit fees deflated by total fees, respectively. OTHERS\_REC and OTHERS\_NREC are recurring and non-recurring other services non-audit fees deflated by total fees, respectively. BUMI is proportion of Bumiputras directors on the board. INSTOWN is percentage ownership by top 5 institutional investors. FAMILY is the proportion of family members on the board of directors. INT\_AUDIT is an indicator variable that takes the value of 1 if the firm outsources its internal audit function, zero otherwise. AUDCOM is proportion of independent directors on audit committee. BOD\_EXPERT is the proportion of finance and accounting expertise on the board of directors. ASSETS is natural log transformation of TOTAL\_ASSETS. DEBT\_EQUITY is total debt deflated by total equity. NEG\_EQUITY is an indicator variable that takes the value of 1 if the firm records a negative equity, zero otherwise. LOSS is an indicator variable that takes the value of 1 if the firm records a loss during the year, zero otherwise. BIG\_4 takes on the value of 1 if the firm is audited by a BIG 4 auditing firm, zero otherwise. Significant p-values are bold. X<sup>2</sup> results are in parenthesis.

**Appendix B: Examples of Financial Restatements**

FIRM	NOTE FROM THE ANNUAL REPORT	TYPES OF RESTATEMENT
A &M Realty Bhd. 2007	The earnings per share and gross dividend per share have been restated after taking into consideration the adjustment for bonus issue on the basis of one (1) new share for every one (1) existing share, and share subdivision into two (2) shares of RM 0.50 each for every one (1) share of RM 1.00 each, which was effected on 28 August 2007.	Accounting rule application failure
2009	Certain comparative figures have been reclassified to conform to current year's financial presentation.	Misrepresentation
Ann Joo Bhd. 2009	A discontinued operation is a component of the Group's business that represents a separate major line of business that is held for sale. Classification as a discontinued operation occurs upon disposal or when the operation meets the criteria to be classified as held for sale, if earlier. When an operation is classified as a discontinued operation, the comparative income statements are restated as if the operation had been discontinued from the start of the comparative period.	Irregularity