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Non-Audit Services and the Corporate Governance of Audit Clients

Khairul Anuar Kamarudin, Wan Adibah Wan Ismail
and Jessieca Cherryl Yatan

Faculty of Accountancy, Universiti Teknologi MARA, Kedah, Malaysia

ABSTRACT

This paper investigates whether firms with strong corporate governance perceive non-audit services (NAS) as a threat to auditor independence or as a mechanism to improve audit quality. The sample consisted of 706 firms listed on Bursa Malaysia in 2014 and employed six proxies for corporate governance. The findings show that firms with a bigger audit committee and a higher proportion of independent members in the audit committee are linked with higher NAS, consistent with the resource-based view. The study also found that audit firms in the Big 4 were paid a higher amount of NAS compared to non-Big 4 firms., in line with the general view that the Big 4 auditors supply higher quality services than the non-Big 4. However, it was also found that a more independent board of directors is associated with a low NAS. This suggests that although the board of directors might perceive NAS a threat to auditor independence, a strong audit committee subscribes to the argument that the benefits outweigh the costs. This study contributes to the present literature on the determinants of NAS in an emerging market and would be informative to regulators worldwide when considering new policies related to NAS.

Keywords: *Financial reporting, corporate governance, non-audit services*

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INTRODUCTION

The provision of non-audit services (NAS) has been a contentious issue worldwide since the Enron debacle in 2002. In the United States, the Sarbanes-Oxley Act was imposed to restore confidence in the capital market where new regulations specify the scope of NAS to clients by auditors and stipulate the annual disclosure of audit fees and NAS fees. The U.S. judicial authorities believe that the offering of NAS hampers the independence of auditors¹. In the Malaysian context, various corporate scandals such as in the Maxbiz Corp Bhd, Transmile Bhd, and most recently 1MDB have given a negative view of the role of auditors in preventing fraud (Wahab, Gist, and Majid, 2014)². In order to ensure the independence of auditors and to protect the interests of investors, various initiatives have been taken. The revised 2002 Malaysian Institute of Accountants (MIA) by-laws provide the ethical rules and guidelines pertaining to providing NAS to audit clients³. These rules permit auditors to provide NAS to audit clients at a level that might not be deemed to compromise independence. Further, the revised Malaysian Code of Corporate Governance (MCCG) 2012 stresses that ‘the independence of external auditors can be impaired by the provision of NAS to the firm’ (Securities Commission, 2002, p.19). As a proactive measure, the revised MCCG 2012 underlines that audit committees should establish policies governing the circumstances under which contracts for the provision of NAS can be entered into and procedures that must be followed by the external auditor⁴. To ensure that independent behaviour is being exercised by the auditor while performing an audit, a written assurance in accordance with terms that are relevant to the profession must be obtained⁵.

1 In 2001, Arthur Andersen charged Enron US\$25 million for auditing services and \$27 million for non-audit services.

2 The Maxbiz Corp Bhd., Transmile Bhd., Megan Media Holdings Bhd. and Tat Sang Bhd. cases signaled accounting irregularities in Malaysia in 2007 and had tarnished auditor reputation. 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. The most recent scandal 1MDB has spurred criminal and regulatory investigations around the world. The Malaysian parliamentary committee identified at least \$4.2 billion in irregular transactions related to 1MDB (Bloomberg news - 24 May 2018).

3 Refer to paragraph 290.156-290.161 MIA By-laws.

4 The compliance with best practice as recommended in the MCCG is voluntary, but public listed firms are required to state in their annual reports the extent to which they have complied with best practices, and the reasons for any non-compliance.

5 The written assurance should state that the external auditor maintains independence during their audit tasks. This essential requirement by MCCG 2012 provides support for the assessment of the external auditor's independence.

Despite the regulatory concerns on the impairment of auditor independence due to the economic bond that is created between the auditor and the client (Agrawal and Chadha, 2005), empirical studies have found mixed arguments and evidence. A recent evidence by Kowalesky, Mayhew, and Tegeler (2018) found that providing consulting services increases auditor cooperation with managers, increasing audit quality when managers prefer high audit quality and decreasing audit quality when managers prefer low audit quality. This supports the argument that when the NAS fees are too high, auditors are likely to acquiesce to clients and hence lose their independence. On the other hand, the opponents of NAS argue that NAS would lead to a high audit quality as a result of knowledge spillover and reputational effects (Simunic, 1984). Frankel, Johnson, and Nelson (2002) found that high NAS fees have negative effects on audit quality which is measured by earnings management. Similar conclusions were also found in Krishnan, Sami and Zhang (2005) and Francis and Ke (2006) when examining pre-SOX period, where audit quality is low in the case of firms with high NAS fees. Lim and Tan (2008) also found high NAS fees to be associated with low audit quality proxied by low propensity to issue a going concern opinion, low propensity to miss analysts' forecasts, as well as low earnings response coefficients⁶. However, it is important to note that the negative effects of NAS on audit quality have not been consistently supported by the available evidence (e.g., DeFond, Raghunandan, and Subramanyam, 2002; Callaghan, Parkash, and Singhal, 2009; Garcia-Blandon, Argiles-Bosch, Castillo-Merino, Martinez-Blasco, 2017; Ashbaugh, LaFond, and Mayhew, 2003; Chung and Kallapur, 2003; Larcker and Richardson, 2004; and Ruddock, Taylor and Taylor, 2006).

Given controversial issues surrounding the NAS, this study examined how corporate governance affects NAS in an emerging market. We posit that if NAS constitutes serious threats to auditor independence, firms with strong corporate governance would minimise or avoid appointing an incumbent auditor for the non-audit work. In Malaysia, corporate governance has undergone few reforms since the introduction of the Malaysian Code of Corporate Governance in the year 2000 especially those relating to the effectiveness of the board and audit committees which aim to improve financial reporting and audit quality. We employed six corporate governance proxies namely, audit committee independence, the frequency

6 Lim and Tan (2008) focus on mitigating effect of auditor specialization on NAS and audit quality relationship.

of audit committee meeting, audit committee size, CEO duality, board independence, and auditor size. Our sample covered 706 firms listed in Bursa Malaysia focusing on 2014, that is two years after the revised 2012 MCCG was launched.

Our findings show that in general, firms with strong corporate governance, particularly bigger audit committee, more independent members of the audit committee and Big 4 audit firms, were associated with high non-audit fees. These findings show that firms with a strong audit committee and high-quality auditors place greater emphasis on the benefits of NAS on auditing and financial reporting rather than its threat on auditor independence. In contrast, the study found that board independence had a negative association with NAS. This shows that the board in general, view that NAS may have a negative impact on the independence of auditors. However, the audit committee, which is ultimately responsible for the the quality of an audit and review of any NAS provided by independent auditors, subscribes to the arguments that NAS brings benefits such as strengthening audit quality due to knowledge spillovers (Wang and Hay, 2013; Jenkins and Krawczyk, 2001) and better reputational effect (Ernst & Young, 2013; Wang and Hay, 2013). Hence, the regulators' concern of incumbent auditors providing NAS seems to be unwarranted in this specific context.

For a sensitivity analysis test, we performed the binary logistic regression where the results support our main findings. We found that firms that purchase NAS have a higher proportion of independent audit committee members and a lower proportion of independent directors on the board compared to firms that do not purchase any NAS. The result also shows that Big 4 auditors are more likely to obtain NAS jobs compared to non-Big 4 auditors.

This study makes the following contributions. First, prior studies were mostly concerned on the implications of NAS on audit quality (e.g. DeFond et al., 2002; Callaghan et al., 2009), but evidence on corporate governance and its relationship to NAS remains scarce. Second, our study adds to a stream of research on the perception of the board of directors, particularly the audit committee, on how they view the effect of NAS on incumbent auditors, especially in an environment where concerted efforts by regulatory bodies are in place. Third, as most of the studies focus primarily on the

United States and developed countries, our study adds more evidence to the research in this stream by investigating the effect of corporate governance and NAS in an emerging market.

The remainder of the paper is organised as follows. The next section reviews the literature and develops the hypotheses. This is followed by the discussion on the research design and sample selection procedures. The paper then reports the findings, conclusions and limitations.

LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Extant studies on NAS have mainly focused on its effects on the quality of audit and financial statements (e.g. Park, Choi, and Cheung, 2017; Bamahros and Wan-Hussin, 2015; Ruddock et al., 2006; DeFond et al., 2002). Most of these studies argue that NAS contributes to the lack of independence of external auditors, and thus becomes one of the key factors in a series of financial scandals.

There are two different underpinning theories on how NAS could be linked to the quality of financial reporting. NAS may be associated with more auditor expertise on the one side and a possible decrease in auditor independence on the other side, which can be referred to as the resource-based view and the principal-agent theory (Velte and Loy, 2018).

According to the resource-based view, NAS provides companies with wider economic benefits due to economy of scope that arises from the joint provision of an audit and NAS. This economy of scope is normally characterised as knowledge spillovers (DeAngelo, 1981). Knowledge spillovers are exchanges of information or ideas between two or more parties which may facilitate the exchange of ideas, promoting creativity and innovation. In the auditing context, knowledge externalities or spillovers would arise from interdependencies or interactions in the production of the two services, namely, the statutory audit and NAS (Simunic, 1984). Based on Demirkan and Demirkan (2017), knowledge generated while performing NAS can spill over into an audit, producing economic rents and reducing audit costs. Knowledge spillovers could result in more efficient audits as auditors have a better understanding of the client's operations.

On the other hand, the proponents of the Principal-agent Theory (e.g. Beck, Frecka, and Solomon, 1988; Palmrose, 1986; Simunic, 1984) argue that NAS may lead to incremental economic rents that are beyond the realm spillover effects. Bortolon, Neto, and Santos (2013) explain that NAS may compromise auditor independence in two ways. First, there is a risk that the auditor becomes financially dependent on the client, fearing the loss of revenue, and avoids giving negative opinions. Therefore, the willingness to report any material misstatement may also be impaired. Second, the provision of consultancy services can place auditors in a position similar to that of managers, which will compromise their judgment. Thus, the ability of the auditors to detect a material misstatement will deteriorate. Auditors are reluctant to report on the finding to the management due to non-audit fees that they have received (Beck et al., 1988). Velte and Loy (2018) highlighted that there is also the possibility of a moral hazard if the auditor and management collaborate. In such a case, the auditor might tolerate faulty financial accounting and grant an unqualified audit opinion in exchange for the benefits of receiving contracts for NAS.

Based on this two contradicting theories, this study examined how firms with strong corporate governance view NAS. We first focussed on the audit committee, which is central for corporate governance. The audit committee is responsible for ensuring that financial statements comply with applicable financial reporting standards and establishing policies and procedures to assess the suitability and independence of external auditors. The MCCG 2012 requires audit committees to establish policies governing the circumstances under which contracts for the provision of NAS can be entered into and procedures that must be followed by the external auditors. We employed three proxies namely audit committee size, audit committee independence and the frequency of audit committee meetings. In addition, we also included other corporate governance proxies such as board independence, CEO duality, and Big 4 auditors.

Size of the Audit Committee and Non-Audit Services

A large number of studies have employed audit committee size as a proxy for corporate governance (Karamanou and Vafeas, 2005; Bedard, Chtourou, and Croteau, 2004; Cornett, McNutt, and Tehranian, 2009; Li, Mangena, and Pike, 2012). Most of the studies tried to examine the effect

of audit committee size on financial reporting quality. Based on economic-related theories, Lipton and Lorsh (1992) and Cornett et al., (2009) argued that bigger groups would have an advantage from individual members' expertise, ideas and manpower, and hence enhance the monitoring and group performance. Further, Bedard et al. (2004) argued that larger audit committees are more likely to reduce potential problems in financial reporting processes because of increased monitoring capacity (Li et al., 2012).

The empirical evidence pertaining to the effect of audit committee size is however mixed (Bedard et al., 2004; Cornett et al., 2009; Li et al., 2012). Several studies have documented a positive association between audit committee size and the quality of financial reporting (Cornett et al., 2009; Lin and Hwang, 2010) and non-financial reporting (Li et al., 2012; Ahmed Haji, 2015). In Malaysia, Ahmad-Zaluki and Wan-Hussin (2010) provide weak evidence that audit committee size is positively associated with the quality of financial information disclosure, proxied by the accuracy of initial public offering management earnings forecast. This is supported by Wan Ismail, Raja Ahmad, Kamarudin, and Yahaya (2009), who found that a larger audit committee has more resources and capabilities, and thus is better in performing the required duties.

However, most of the studies reviewed by Bedard and Gendron (2010) indicate that the size of the audit committee is not an important determinant of effectiveness, and they caution that the incremental costs of poorer communication, coordination, involvement and decision making associated with a larger audit committee might outweigh the benefits. According to John and Serbet (1998), larger committees could be associated with dispersed opinions and lack of quick decision-making potentially undermining their effectiveness. This also could be due to the problem of free riders that may emerge when the number of audit committee members increases, where the members may be comforted by the presence of others (Karamanou and Vafeas, 2005). Given the competing theoretical views and mixed empirical evidence, as well as lack of prior studies that specifically examined the role of audit committee independence in NAS, this study tested the hypothesis that there is an association between audit committee size and NAS.

Audit Committees Independence and Non-Audit Services

Audit committee independence is a central characteristic of good corporate governance as discussed in both the academic research, as well as regulatory requirements (Abbott, Parker, and Peters, 2003). In Malaysia, the revised MCCG 2012 requires audit committees to comprise only of independent directors. A more independent audit committee avoids any personal interest since the independent audit committee members do not have any personal interest similar to the managers or shareholders, hence leading to a more objective decision. The socio-political theories contend that the existence of independent directors in audit committees is symbolic with aims for organisational legitimacy (Beasley, Carcello, Hermanson, and Neal, 2009).

There is much evidence showing the importance of audit committee independence in establishing good governance such as in selection of external auditors (DeZoort and Salterio, 2001), reducing fraudulent reporting practices (Abbott, Parker, Peters, and Raghunandan, 2003; Bedard et al., 2004), and enhancing financial reporting quality and credibility (Li et al., 2012); García-Meca and Sánchez-Ballesta, 2009; Lin and Hwang, 2010). Chen, Moroney, and Houghton (2005), for instance, found that an independent audit committee has a greater tendency to appoint industry specialist auditors. Archambeault and DeZoort (2001) found that audit committee independence is negatively limited with the probability of firms dismissing auditors following a changing an audit opinion or disputes. Further, Carcello and Neal (2003) showed that the independence of the audit committee is negatively associated with the likelihood of auditor appointment following a “going concern report.” The meta-analyses also show that audit committees are significantly related to lower earnings management (García-Meca and Sánchez-Ballesta, 2009; Lin and Hwang, 2010)

With regard to auditor-client relationship, an independent audit committee is more confident with financial reports audited by external auditors (Abbott and Parker, 2000) and appreciate the external auditor’s position (DeZoort and Salterio, 2001). Moreover, independent directors have strong incentives to scrutinize managerial decisions with regard to the provision of NAS in order to reduce the potential threat to auditors’

reporting quality (Abbott et al., 2003). In this study, we posit that external auditors who also provide NAS would have greater incentives to supply high-quality audits and would be able to improve their services more effectively. In addition, as the committee may bear higher director liability and litigation risks, we predict that NAS will be employed as a mechanism to improve audit quality. Thus, the second hypothesis is that there is a positive relationship between audit committee independence and NAS.

Audit Committee Meetings and Non-Audit Services

The frequency of audit committee meetings signals the commitment of the members to fulfill responsibilities (Abbott et al., 2003). Prior studies claim that more frequent audit committee meetings indicate committee activeness and by extension effectiveness (Abbott et al., 2000; Karamanou and Vafeas, 2005). Audit committees which meet regularly shall have enough time to carry out their roles and functions effectively (Karamanou and Vafeas, 2005). Raghunandan, Rama, and Scarbrough (1998) argue that by meeting frequently, the audit committee will remain informed and be knowledgeable about accounting or auditing issues and can direct internal and external audit resources to address the matter in a timely fashion. During the audit committee meeting the problems encountered in the financial reporting process are identified, but if the frequency of the meetings is low the problems may not be rectified and resolved within a short period of time.

Many studies have documented a significant positive association between financial reporting quality and audit committee meetings (Abbott et al., 2003; Karamanou and Vafeas, 2005). Abbott et al. (2003) examined whether audit committee characteristics are associated with NAS. Their findings suggest that audit committees that are independent and meet at least four times a year purchase less NAS from the auditor. In another study, Krishnan and Visvanathan (2008) showed a positive association between the number of audit committee meetings and a higher audit quality. Abbott and Parker (2000) examined the relationship between the frequency of audit committee meetings and auditor's industry specialisation. Indeed, they found that the number of audit committee meetings is associated with increases in the choice of a better-quality audit firm. Studies have also shown that the frequency of audit committee meetings has a significant impact on non-financial disclosures (Li et al., 2012; Ahmed Haji, 2015). However, there are also studies that found no association between audit committee meetings and reporting quality (Bedard et al., 2004).

Little is known about the impact of audit committee meetings on NAS. We argue that audit committees that meet more often are more likely to perceive NAS as an important mechanism to improve audit quality and financial reporting or they might also perceive NAS as a potential threat to auditor independence. Given the conflicting theoretical views and mixed empirical findings, we developed a competing hypothesis to predict the association between audit committee meetings and NAS. Thus, we hypothesized that a firm that has a higher number of audit committee meetings is associated with higher NAS.

Board Independence and Non-Audit Services

A company's board of directors is viewed as one of the corporate governance mechanisms that is very important to monitor management's corporate decisions and safeguard shareholders' interests. Independent directors are basically more preferable as they could increase the effectiveness of the board monitoring function and ensure that high-quality earnings are reported in the financial statements.

Extant studies on corporate governance support the view that a more independent board would perform a better monitoring function, which would consequently result in a higher level of earnings. For example, higher independence of the board of directors is found to be associated with earnings informativeness (Petra, 2007), lower earnings management (Gul, Fung, and Jaggi, 2009; Niu, 2006; Klein, 2002), and lower abnormal accruals (Peasnell, Pope and Young, 2005).

A study by Larcker and Richardson (2004) found that a lower percentage of independent members of the board is related to a higher NAS. This is consistent with the view that a more independent board of directors prefers a lower NAS, due to the fear that high fees paid for NAS could impair the independence of the external auditor and the quality of their statutory audit. Therefore, a more independent board of directors would limit the company's purchase of NAS. On the other hand, Adelopo and Jallow (2008) found that board independence is positively associated with audit and non-audit fees paid to the auditor. They argue that this could be due to the reason that an independent board plays a crucial oversight function on the management and hence an independent board likely to purchase more

services from the external auditor to signal a board's competence and the quality of the audit.

Thus, this study also tested the hypothesis that there is a relationship between board independence and NAS.

CEO Duality and Non-Audit Services

The dual CEO and chairperson roles held by a single person or known as CEO duality is one of the most controversial issues in corporate governance. Those against CEO duality believe that the CEO and chairperson should be separated, consistent with the agency theory. CEO duality would enhance CEO entrenchment and impair board independence (Finkelstein and D'Aveni, 1994; Rhoades, Eisenberger, and Armel, 2001). Finkelstein and D'Aveni (1994) contend that CEO entrenchment occurs when managers obtain so much power that they are able to use the firm for their own interests rather than those of shareholders, rendering the board ineffective. When a single person holds both roles, it indicates a sign of a dominant CEO where internal monitoring and control mechanism is compromised (Kholief, 2008). Further, Dalton and Dalton (2005) assert that separating the roles of CEO and COB potentially leads to confusion and lack of clarity, both internally with employees and externally with other stakeholders.

In contrary, there are also arguments that the benefits of CEO duality outweigh the negative aspects. According to the stewardship theory (Davis, Schoorman, and Donaldson, 1997; Clarke, 2007), CEO duality reduces concerns regarding accountability since the confidence was given to agents to act in the best interests of all relevant parties involved, including principals. Finkelstein and D'Aveni (1994) also argued that a unity of command enables dual CEOs to act quickly and decisively. In the event of strong external threats such as hostile takeovers, the survival of the firm demands the centralization of power and tightened controls (Alvarez and Svejnova, 2005).

Empirical evidence on the effects of CEO duality on firm's performance and financial reporting are still mixed and inconclusive (see, for example, Dalton, Daily, Ellstrand, and Johnson, 1998; Kang and Zardkoohi, 2005). Some prior empirical tests support the separation of the roles of the CEO and

chairperson (Chen, Lin, and Yi, 2008), while others suggest that combining these two roles is preferable (Coles, McWilliams, and Sen, 2001). In the Malaysian context, the Malaysian Code on Corporate Governance (2012) recommends firms to split the function between CEO and chairperson. This is because the duality role of CEO could result in higher agency costs. According to Parkash and Venable (1993) and Firth (1997), firms with higher agency costs are expected to require higher audit quality to reassure investors and creditors about the integrity of financial statement information, and hence limit their purchase of NAS from their incumbent auditor. Thus, this study hypothesised that there is a relationship between CEO duality and NAS.

Big 4 Auditor and Non-Audit Services

Velte and Loy (2018) highlighted that big audit firms are connected with a higher independence in appearance and have a better potential to offer a range of additional services. Big 4 firms have more resources that lead to a more efficient information system, personal training and quality control systems that enable more effective learning processes. Therefore, Big 4 clients have more potential to subscribe to NAS offered by their auditors.

Dey, Robin, and Tessonni (2012) suggest that the Big 4 accounting firms may be tempted to shed their audit clients by providing them with consulting services. This is because it is more profitable than having statutory audit engagements. Goldwasser and Morris (2002) also argue that by providing NAS, Big 4 auditors can enhance the income of their audit firms and improve their viability in the accounting industry and relieve price competition for audit services. Additionally, Big 4 firms usually promote the idea that the expertise developed by their consulting professionals can improve the quality of audit engagements that utilize these consultants as specialists. Big 4 firms also can assign personnel from their consulting practices to act as specialists in their audit engagement teams. For example, in its 2013 audit quality report, Deloitte states that ‘the utilisation of its financial advisory, tax, and consulting professions as specialists on audit engagements is an indispensable asset that contributes to the quality of their audits’. An empirical study by Abbott et al. (2003) also found the evidence that the non-audit fees to total audit fees ratios are higher for larger firms and for clients of Big 4 auditors.

On the other hand, for non-big 4 audit firms, the number of industry experts and specialist are limited. These small audit firms also have restricted ability and resources. Thus, they may not be able to provide NAS, e.g. consultation, especially to the large multinational corporations, in which global resources are needed to deal with the complex business and financial reporting environments. With that, this study tested the hypothesis that there is a positive relationship between NAS and the Big 4 auditors.

RESEARCH DESIGN

Sample Selection and Data Collection

To investigate the relationship between corporate governance and NAS, this study used a sample of Malaysian publicly traded firms from Bursa Malaysia in 2014. The initial sample consisted of 814 firms. We extracted the accounting data from the Thomson Reuters database, while the data for non-audit service fees, audit committee size, audit committee independence, the frequency of audit committee meeting, CEO duality and Big 4 auditors were collected directly from the firms' corporate annual reports⁷. We then removed all missing data to construct related variables. Finally, to mitigate the influence of outliers, we winsorised the observations that fell in the top and bottom 0.5 percent of the continuous variables (Wan Ismail, Kamarudin, and Sarman, 2015). These procedures left us with a final sample of 706 firms.

⁷ The Thomson Reuters database was accessed at Universiti Teknologi Mara, Malaysia.

Regression Model

Following previous studies (e.g. Carcello, Hermanson, Neal, and Riley, 2002), this study used the OLS multivariable linear regression to examine the association between explanatory variables and fees for NAS. The regression model is as follows:

$$\begin{aligned} \text{NAS} = & \beta_0 + \beta_1 \text{ACSIZE} + \beta_2 \text{ACIND} + \beta_3 \text{ACMEET} + \beta_{14} \text{CEODUAL} \\ & + \beta_5 \text{BODIND} + \beta_6 \text{BIG4} + \beta_7 \text{SIZE} + \beta_8 \text{PROFIT} + \beta_9 \text{LEV} \\ & + \beta_{10} \text{GROWTH} + \beta_{11-20} \text{Industry Effects} + \varepsilon \end{aligned} \quad (1)$$

ACSIZE is the number of members of the audit committee; ACIND is the percentage of independent directors to the total number of audit committee members; ACMEET is the number of audit committee meetings held during the financial year; CEODUAL is a dummy variable that takes value 1 if the chairman is also the CEO of the firm, 0 otherwise; BODIND is the proportion of independent directors over the total board size; BIG4 takes value 1 if firms are audited by Big 4, 0 otherwise; SIZE is the natural log of total assets; PROFIT is earnings before interests and taxes (EBIT) deflated by total assets; LEV is the proportion of total debt to total assets; GROWTH is the percentage change in current year sales compared with the previous year; Industry effects are dummy variables for industry that takes value 1 for consumer products, finance, hotels, industrial products, plantation, infrastructure project corporation, properties, real estate investment trusts, trading and services, and technology respectively, otherwise 0

We included several control variables. First, firm size (SIZE), measured using the natural log of total assets, was included because large firms have a higher need for consultancy and therefore purchase higher amounts of NAS and therefore an assumption of a positive correlation between size and NAS fee exists (Chung and Kallapur, 2003; Hay et al., 2006, p. 158). Zaman, Hudaib, and Haniffa (2011) found that larger clients are more likely to purchase higher levels of NAS due to the complexity of their operations and as a means of ensuring a high-quality audits. Second, firm profitability (PROFIT) is found to have a positive association with the levels of the NAS fee ratio (Parkash and Venable, 1993). Third, leverage (LEV), measured as the ratio of total debt to total assets, has a positive link to agency costs thereby auditors become more concerned about their reputational capital and

purchase less NAS (Taufil-Mohd, Md-Rus, and Mussalam, 2013; Parkash and Venable, 1993). Fourth, we included growth (GROWTH), measured as the percentage change in current year sales compared with the previous year, where we expect a positive relationship between NAS fee ratio and Growth since firms with high growth opportunities are likely to purchase more NAS because of rapid expansion in activities and a fast-changing environment might stretch senior executives' abilities to manage, therefore requiring a firm to hire more consultants (Firth, 1997). Finally, we included dummy variables for the industry to measure the fixed effect of the industry to ensure the robustness of the result (Kamarudin, Wan Ismail, and Alwi, 2014).

RESULTS AND FINDINGS

Descriptive Statistics

The descriptive statistics of the variables are illustrated in Table 1. Panel A Table 1 shows descriptive statistics for the continuous variables, while Panel B reports the dichotomous variables.

The results reported in Panel A show that the average payment of NAS is RM 0.267 million with a standard deviation of RM2.684. The payment of NAS ranged from a minimum of RM0 to a maximum of RM67 millions, indicating that the sample consists of a top-level firm that is able to pay such a high NAS. On the other hand, the average for natural log of NAS (LNAS) was 8.776 with a standard deviation of 4.170. For audit committee size (ACSIZE), the results show that the mean was 3.358 with the minimum size of the audit committee of two members and the maximum size of 9 members. While for audit committee independence, Panel 1 shows that a mean for ACIND was 0.884 showing that the audit committee is dominated by independent directors. However, this scenario still showed that not all publicly listed firms in Malaysia comply with the recommendation of revised MACC 2012 which suggests that all audit committee members should be independent. The results denote that in average the audit committee met 4.97 times during the year, with a range between 1 to 15 meetings, which is higher than recommendation set out in the MCCG where the audit committee should meet at least four times per year. The mean for BODIND was at 0.477, indicating that the majority members of the board of directors are

internal members, while outsiders only comprised 47.7 percent which can still be considered high.

**Table 1 Descriptive Statistics
Panel A: Continuous Variables**

Variables	Minimum	Maximum	Mean	Std. Deviation
<i>NAS(million)</i>	0.000	67.000	0.267	2.684
<i>LNAS</i>	0.00	18.02	8.776	4.170
<i>ACSIZE</i>	2.000	9.000	3.358	0.705
<i>ACIND</i>	0.220	1.000	0.884	0.156
<i>ACMEET</i>	1.000	15.000	4.970	1.259
<i>BODIND</i>	0.140	1.000	0.477	0.130
<i>SIZE</i>	6.869	11.806	8.731	0.712
<i>PROFIT</i>	-3.963	3.159	0.128	0.322
<i>LEV</i>	0.00	6.591	0.201	0.301
<i>GROWTH</i>	-1.000	30.765	0.143	1.302

Panel B: Dichotomous Variables

Dummy Variables	Frequency			Percentage		
	Yes (1)	No (0)	Total	Yes (1)	No (0)	Total
<i>NASDUM</i>	591	115	706	83.71	16.29	100.00
<i>BIG4</i>	372	334	706	52.69	47.31	100.00
<i>CEODUM</i>	411	295	706	58.20	41.80	100.00

Variable definitions: NAS is the amount of non-audit services paid to incumbent auditor during the year; LNAS is the natural logarithm of NAS paid during the year; NASDUM is a dummy variable that takes value 1 if the firm higher the incumbent auditor to perform NAS, otherwise 0; ACSIZE is the number of members of the audit committee; ACIND is the percentage of independent directors to the total number of audit committee members; ACMEET is the number of audit committee meetings held during the financial year; CEODUAL is a dummy variable that takes value 1 if the chairman is also the CEO of the firm, 0 otherwise; BODIND is the proportion of independent directors over the total board size; BIG4 takes value 1 if firms are audited by Big 4, 0 otherwise; SIZE is the natural log of total assets; PROFIT is earnings before interests and taxes (EBIT) deflated

by total assets; LEV is the proportion of total debt to total assets; GROWTH is the percentage change in current year sales compared with the previous year; IND takes the value 1 for a specific industry, 0 otherwise. CP, FIN, HOTELS, INDP, IPC, PLANT, PROP, REITS, T&S, and TECH are dummy variables for industry that takes value 1 for consumer product, finance, hotels, industrial product, plantation, infrastructure project corporation, properties, real estate investment trusts, trading and services, and technology respectively, otherwise 0.

For firm size (SIZE), the results showed the mean value for the natural logarithm of total assets was 8.731, with a maximum value of 11.806 and the minimum value of 6.869. The mean value for PROFIT is 0.128, while the maximum value was 3.159 and the minimum value is -3.963. The results also showed that the mean value for LEV was 0.201 with a standard deviation value of 0.301. For GROWTH, the mean value was 0.143 with a range between -1.000 and 30.765.

The results in Panel B Table 1 for NASDUM shows that most of the firms (with 83.71% of the total sample) appointed the incumbent auditor for NAS where only 16.30% of the firms did not pay NAS. Besides that, the result showed that more than half of the sample with 52.69% appointed Big 4 auditors and the remaining 47.31% appointed non-Big 4. As for CEODUM, it showed that most of the sample (58.20%) did not comply with the MCCG to have a separation between the Chairman and CEO.

Correlation Matrix

Table 2 presents the correlation coefficient matrix with the Pearson Correlation Coefficients in the lower diagonal and the Spearman Rank Correlation Coefficients in the upper diagonal.

Table 2: Correlation Matrix

	ACSIZE	ACIND	ACMEET	CEODUM	BODIND
ACSIZE	1.000	-0.159***	0.014	-0.031	0.098***
ACIND	-0.192***	1.000	0.050	0.027	0.332***
ACMEET	-0.014	0.062	1.000	0.065	-0.024
CEODUM	-0.026	0.029	0.065	1.000	0.026
BODIND	0.088**	0.315***	-0.013	0.038	1.000
BIG4	0.224***	-0.110***	-0.033	0.003	-0.043
SIZE	0.244***	-0.116***	0.020	0.083**	-0.060
PROFIT	0.147***	-0.120***	0.017	-0.011	-0.042
LEV	0.030	0.001	0.000	0.069*	-0.031
GROWTH	-0.022	0.039	0.008	0.048	0.022

	BIG4	SIZE	PROFIT	LEV	GROWTH
ACSIZE	0.217***	0.229***	0.123***	0.075**	-0.013
ACIND	-0.100***	-0.119***	-0.110***	-0.036	-0.003
ACMEET	-0.033	0.011	-0.002	-0.012	-0.011
CEODUM	0.003	0.084**	0.020	0.065	0.022
BODIND	-0.041	-0.076**	-0.111***	-0.065	-0.106***
BIG4	1.000	0.429***	0.285***	0.055	0.083**
SIZE	0.420***	1.000	0.483***	0.279***	0.172***
PROFIT	0.180***	0.324***	1.000	-0.143***	0.316***
LEV	0.045	0.040	-0.111***	1.000	-0.011
GROWTH	0.056	0.116***	0.144***	-0.006	1.000

Notes: * and *** represent significance at p<0.10 and <0.01, respectively

Variable definitions: ACSIZE is the number of members of the audit committee; ACIND is the percentage of independent directors to the total number of audit committee members; ACMEET is the number of audit committee meetings held during the financial year; CEODUAL is a dummy

variable that takes value 1 if the chairman is also the CEO of the firm, 0 otherwise; BODIND is the proportion of independent directors over the total board size; BIG4 takes value 1 if firms are audited by Big 4, 0 otherwise; SIZE is the natural log of total assets; PROFIT is earnings before interests and taxes (EBIT) deflated by total assets; LEV is the proportion of total debt to total assets; GROWTH is the percentage change in current year sales compared with the previous year.

The results showed no serious multi-collinearity problem. The highest correlation was between BIG4 and SIZE at 0.420 (Pearson) and 0.429 (Spearman Rank) which was significant at the 1% level. Whereas, ACIND and BODIND had a positive relationship with a significant level of 1% for both Pearson = -0.315 and Spearman Rank = -0.332. This shows that a company with higher audit committee independence also has more outside directors in the board. On the other hand, the result showed that BIG 4 and CSIZE had a negative correlation at the 1% level for Pearson (-0.224) and 10% level for the Spearman Rank (-0.217) which indicated that companies that appoint BIG 4 firms tend to have smaller audit committees. From the explanation above, we can summarise that there is no multicollinearity problem between the independent variables⁸.

Empirical Results

Table 3 presents the results from three estimations: basic OLS model, Heteroscedasticity-adjusted model⁹ and fixed-effect estimates which control for the industry effects¹⁰.

The findings showed that the coefficients for BODIND are negative and significant in all three estimations, showing

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- 8 Kaplan (1982) suggests that multicollinearity may be a problem when the correlation between independent variables is 0.90 or above. However, Emory (1982) considered more than 0.80 to be problematic. This is further supported by Grewel, Cote and Baumgartner (2004), they had found that if the correlation is over 0.8 considered as extreme.
- 9 Heteroscedasticity problem occurs when the variance of the errors varies across observations. If the errors are heteroscedastic, the OLS estimator remains unbiased, but becomes inefficient. More importantly, estimates of the standard errors are inconsistent. The estimated standard errors can be either too large or too small, in either case resulting in incorrect inferences.
- 10 This study controlled for serial correlation problems of residuals data by incorporating industry in the regression model. By using the Bursa Malaysia's sector classification, this study creates ten industry dummies: Consumer Product (CP); Finance (FIN); Hotels; Industrial Product (IND); Infrastructure Project Co. (IPC); Plantation (PLANT); Property (PROP); REITS; Trading and Services (T&S) and Technology (TECH). The construction sector is not included in the equation because it is used as a base sector to avoid perfect multi-collinearity problem.

that NAS is lower in firms with more a independent board of directors. This is consistent with Bedard and Paquette (2011) that a more independent board of directors would not approve a big amount of NAS fees because it would give negative effects on their reputation. Contrary to the expectation, the results showed that the coefficients for ACSIZE and ACIND were positively significant in all three models, suggesting that firms with a bigger audit committee and a higher proportion of independent member of the audit committee are linked with higher NAS. Our results are consistent with Zaman et al. (2011), who found that NAS has a positive relationship with audit committee effectiveness especially for larger clients, probably due to the complexity of the business activities. From these results, we can posit that, in general, board independence is linked to a lower NAS which is consistent with the general concern that NAS might impair auditor independence. However, in the context of the audit committee, NAS was perceived to bring benefits to firms, such as high audit quality due to the knowledge spillover effect. Hence firms with the larger audit committee and a high proportion of independent audit committee members would pay more NAS fees than other firms. As audit committee members are responsible for overseeing financial reporting and related internal controls and risks, they have greater incentives to engage incumbent auditors for NAS, especially when they have less knowledge about the firm. The MCCG 2012 also requires audit committees to ensure financial statements comply with applicable financial reporting standards. The audit committee hence welcomes advice from the experts, particularly external auditors.

We also found that the coefficients for BIG 4 in all three estimations were positively significant at the 1% level, showing that firms with Big 4 auditors were paid a higher amount of NAS compared to firms with non-Big 4 auditors. This is consistent with Goldwasser and Morris (2002), which found that the Big 4 audit firms are more likely to provide NAS, to enhance their income for their audit firms. Meanwhile, the coefficients for CEO duality and audit committee meetings were not significant.

Table 3: Regression Estimates

Variable	Ordinary Least Square		Heteroscedasticity Adjusted		Controlling Industry Effects	
	Coeff.	t-stat	Coeff.	White-t	Coeff.	t-stat
Intercept	-7.170***	-3.205	-7.170***	-3.705	-8.492***	-3.293
ACSIZE	0.395*	1.820	0.395*	1.915	0.373*	1.716
ACIND	2.660***	2.673	2.660***	2.597	2.769***	2.747
ACMEET	0.045	0.374	0.045	0.413	0.006	0.049
CEODUAL	-0.289	-0.995	-0.289	-0.991	-0.190	-0.652
BODIND	-2.423**	-2.063	-2.423**	-2.059	-2.860**	-2.412
BIG4	1.853***	5.809	1.853***	5.969	1.762***	5.497
SIZE	1.397***	5.649	1.397***	6.450	1.550***	5.669
PROFIT	0.899*	1.882	0.899***	2.947	0.851*	1.771
LEV	0.417	0.874	0.417	1.186	0.539	1.127
GROWTH			-0.028	-0.397	-0.044	-0.394
CP					0.661	0.935
FIN					0.919	0.974
HOTELS					3.388*	1.708
INDP					0.356	0.544
IPC					0.908	0.508
PLANT					0.626	0.726
PROP					-0.835	-1.120
REITS					-3.432**	-2.321
T&S					0.486	0.724
TECH					1.176	1.240
Adjusted R ²	0.18		0.18		0.20	
N	706		706		706	
F-stat	16.850		20.036		9.586	

Notes: * and *** represent significance at p<0.10 and <0.01, respectively

Variable definitions: ACSIZE is the number of members of the audit committee; ACIND is the percentage of independent directors to the total number of audit committee members; ACMEET is the number of audit committee meetings held during the financial year; CEODUAL is a dummy variable that takes value 1 if the chairman is also the CEO of the firm, 0 otherwise; BODIND is the proportion of independent directors over the total board size; BIG4 takes value 1 if firms are audited by Big 4, 0 otherwise; SIZE is the natural log of total assets; PROFIT is earnings before interests and taxes (EBIT) deflated by total assets; LEV is the proportion of total debt to total assets; GROWTH is the % change in current year sales compared with the previous year; CP, FIN, HOTELS, INDP, IPC, PLANT, PROP,

REITS, T&S, and TECH are dummy variables for industry that takes value 1 for consumer product, finance, hotels, industrial product, plantation, infrastructure project corporation, properties, real estate investment trusts, trading and services, and technology respectively, otherwise 0.

For the control variables, the coefficients for SIZE and PROFIT had a significant and positive value suggesting that large and more profitable firms tend to purchase NAS. This supports the evidence found by Palmrose (1986) and Firth (1997), supporting the arguments that larger firms are more likely to have complex systems and a wider range of activities, both of which provide greater opportunities for auditors to provide NAS. Further, the positive significant relationship between profit and the level of purchasing NAS is in line with Parkash and Venable (1993). For growth and leverage, no significant association was found.

Robustness Tests

To ensure the robustness of our results, we employed the binary logistic regression to determine how much variance is explained on firms' decision to purchase or not to purchase NAS (NASDUM) by corporate governance attributes. In the binary logistic regression, we used NASDUM as the dependent variable, which took value 1 for a firm with NAS and 0 for otherwise, while other variables remained. The regression estimates are reported in Table 4.

Table 4: Regression Estimates using Binary Logistic Regression

Variable	Coeff.	Z-stat	P-value
Constant	-3.265*	-1.714	0.086
ACSIZE	0.278	1.333	0.182
ACIND	1.461*	1.942	0.052
ACMEET	0.048	0.455	0.649
CEODUAL	-0.198	-0.9	0.368
BODIND	-1.905**	-2.218	0.027
BIG4	1.016***	4.056	0.000
SIZE	0.347*	1.683	0.092
PROFIT	0.562	1.414	0.157
LEV	0.074	0.22	0.826

GROWTH	0.475	1.358	0.174
Pseudo R ²	0.09		
N	706		
LR chi ²	58.31		

Notes: * and *** represent significance at p<0.10 and <0.01, respectively.

Variable definitions: ACSIZE is the number of members of the audit committee; ACIND is the percentage of independent directors to the total number of audit committee members; ACMEET is the number of audit committee meetings held during the financial year; CEODUAL is a dummy variable that takes value 1 if the chairman is also the CEO of the firm, 0 otherwise; BODIND is the proportion of independent directors over the total board size; BIG4 takes value 1 if firms are audited by Big 4, 0 otherwise; SIZE is the natural log of total assets; PROFIT is earnings before interests and taxes (EBIT) deflated by total assets; LEV is the proportion of total debt to total assets; GROWTH is the % change in current year sales compared with the previous year;

The results show that the coefficient for ACIND was positively significant which was consistent with our main results. The results suggest that firms that purchase NAS have a higher proportion of independent audit committee members compared to firms that do not purchase any NAS. The result also shows that the coefficient for BODIND is negative suggesting that firms that purchase NAS are associated with firms with a lower proportion of independent directors on the board. We found that the coefficient for BIG 4 is positively significant (at the 1% level), showing that Big 4 auditors are more likely to obtain NAS job compared to non-Big 4 auditors. These results support our main findings.

CONCLUSIONS

In this paper, we examined the effect of corporate governance on NAS. Prior studies have concentrated on the effect of NAS on audit quality, but the results were mixed and inconclusive (e.g. Frankel et al., 2002; Ashbaugh et al., 2003; Chung and Kallapur, 2003; and Larcker and Richardson, 2004). In line with these findings, our study has documented that NAS is lower in firms with a more independent board of directors, consistent with

Bedard and Paquette (2011)'s argument that a more independent board of directors would not approve the big amount of NAS fees because it would give negative effects on their reputation. More interesting, contrary to expectations, our study found that firms with a bigger audit committee and a higher proportion of independent members in the audit committee are linked with a higher NAS, consistent with Zaman et al. (2011), showing a higher demand for NAS probably due to the complexity of the business activities, perceived NAS benefits, or heightened responsibility of audit committee members in overseeing financial reporting and related internal controls and risks. Our results support the view that the accumulation of client-specific knowledge, as a result of NAS, could lead to high-quality audits and financial reporting. We have added to the existing literature by providing evidence on how different proxies for corporate governance respond to issues on NAS. The findings of this paper will be of use to financial reporting regulatory authorities in Malaysia such as the Securities Commission of Malaysia, Bursa Malaysia as well as the Malaysian Institute of Corporate Governance, regarding the different corporate governance roles played by auditors pertaining to NAS. Several limitations that have arisen from the data availability need to be considered in this study. Firstly, the NAS data reported on the financial statements was limited since there were no specific rules or disclosure requirements. Though firms report the total amount paid for NAS, disclosure on the nature and scope of NAS are limited, so we were not able to distinguish the decision on different types of NAS such as audit-related or tax-related services. Future studies could investigate this issue using different methods such as a survey or a case study.

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