

NON-AUDIT SERVICES AND AUDITOR INDEPENDENCE IN MALAYSIA: KNOWLEDGE SPILLOVER IN CONSTRUCTION COMPANIES

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Abstract: The study examines the relationship between non-audit services (NAS) and auditor independence in construction companies in Malaysia. The study also considers other control variables that contribute to the independence of auditor such as leverage, big4, loss, family firm, auditor ethnicity, capital intensity, audit fee and audit committee independence. The study employs descriptive analysis, univariate tests and multivariate regression to investigate the potential effect of NAS on auditor independence. The data for NAS and other control variables were hand collected from annual reports downloaded from Bursa Malaysia's website. Based on 147 firm-year observations from construction companies for the period 2017-2019, the study found that the joint produce of audit and NAS did not compromise auditor independence. This empirical result failed to prove the economic bond created between auditors and clients that restricted the auditors from performing their duty objectively. The finding supports the argument of knowledge spillover in which while doing audit, the auditor gains experience and yield audit efficiency. These results contribute to Malaysia's policy deliberation to account for the effects of NAS on auditor independence using the direct method of audit opinion. This study contributes to theoretical perspectives on knowledge spillover which is very limited in Malaysia.

Keywords: Auditor independence, audit opinion, NAS, knowledge spillover, economic bonding, audit quality

1. Introduction

Auditor independence is the key in bridging information asymmetry gap between owners of entities and their agents (Panda & Leepsa, 2017; Mardiah & Muda, 2018). Agency theory, in the views of many scholars (Jensen & Meckling, 1976; José & Almeida, 2014; Panda & Leepsa, 2017) postulates that information asymmetry influences objective scrutiny of financial statements and agency problems. The principal-agent relationship is illustrated in agency theory which stipulates that the principals lack reasons to believe in their agents because of information asymmetries and conflicting interest. Therefore, information asymmetry during decisions making occurs when one party is more informed than the other party. The agency theory provides the theoretical underpinnings to support the position of auditors' independence in bridging information asymmetry gap between principal and agent.

Past studies (Simunic, 1984; DeFond & Zhang, 2014) link auditor independence to audit quality. Many studies have been conducted to explore this issue using various approaches such as accrual methods (Srinidhi & Gul, 2007; Manry et al., 2008; Abdul Wahab et al., 2020), audit opinion (Robinson, 2008; Callaghan et al., 2009; Ye et al., 2011; Ratzinger-Sakel, 2015; Zhang et al., 2016) and restatement (Kinney et al., 2004; Paterson & Valencia, 2011; Abdul Wahab et al., 2014). However, there is very scarce empirical evidence that connects both audit opinion as a proxy to auditor independence in Malaysia.

While most studies on auditor independence have restricted the analysis to financially distressed companies and have examined only Going-Concern Modified Opinions (GCMO) (Carey & Simnett, 2006; Ye et al., 2011), some studies have followed a more comprehensive approach and have included all types of firm and audit qualifications into the analysis (Chi & Chin, 2011; Firth et al., 2012). Accordingly, the issuance of qualified opinions (not only GCMOs) by the auditor represents an exercise of independence. Most prior research measured independence by the opinion of the audit report being conducted in high litigation risk countries

(Carey & Simnett, 2006; Ye et al., 2011). In these countries, potential litigation costs should provide strong incentives to auditors to preserve independence. Hence, it is questionable whether this framework is still valid in a low litigation risk country such as Malaysia.

The collapse of many huge companies as well as audit firms around the world raised doubt regarding the credibility of accounting and auditing profession as to whether auditors still remain independent. Do they conduct their responsibility with full integrity and in line with their objectivity? Do they still work for the public interest? Can we as public eyes trust them? These questions bear in public's mind for quite some time recently. As for the well-known international cases involving the failure of auditing role as well as corporate government such as Enron, Satyam, WorldCom, and also not forgetting local cases such as Transmiles case in 2007, people have lost their trust in accounting and auditing profession.

This study investigates the issue of auditor independence in Malaysia focusing on non-audit services among construction companies listed on the Main Market of Bursa Malaysia. This is because construction industry in Malaysia has been linked to various scandals of corruption and fraud cases over the years, which raised a question mark on the ability and the functionality of auditor who is supposed to exercise professional skepticism, dig information, and report any found breach. Construction industry in Malaysia has been identified as a high-risk of exposure towards fraud and corruption compared to other industry as reported by The Malaysian Anti-Corruption Commission (MACC). Thus, here we see a great opportunity to test the level of independence among auditors in this industry.

The objective of the study is to examine the relationship between non-audit services and auditor independence which is proxy by audit opinion. We document positive relationship between NAS and auditor independence, which support the perspective of knowledge spillover. This study will contribute to the institutions and practitioners in understanding and setting the regulation as well as strengthening the current rules and regulation on the provision of non-audit services of a company. Besides, this study will also help to dig information and evidence to broaden the views and understand the construction industry in Malaysia for revising the rules and regulation. This study will also contribute to the literatures by filling the gap and adding a crucial evidence on the discussion of auditor independence, especially those that related to construction companies in Malaysia which are currently scarce.

Section 2 proceeds with the literature review and hypothesis development. Section 3 presents research method. Section 4 highlights the results and section 5 concludes.

2. Literature Review and Hypothesis Development

Prior research provides mixed evidence on the relationship between NAS and auditor independence. Whether NAS negatively or positively affect auditor independence is still in uncertainty. Certain findings demonstrated that the quality of financial reporting declines with the provision of NAS from the auditor (Ferguson et al., 2004; Larcker & Richardson, 2004; Abu Bakar, 2018). On the other hand, the study of Ashbaugh et al. (2003) did not show a positive relationship between NAS and earnings management, which indirectly impair auditor independence. This argument is supported by Kinney et al. (2004) where they stated that tax consulting can increase the quality of financial reporting. This argument is based on the assumption that the provision of NAS can improve financial audit through knowledge spillover and provide a better understanding of client business environment to the auditor (Simunic, 1984).

From economic perspective, auditors provide joint provision of NAS and audit services for the sake of cost efficiency, where the auditor can actually reduce the 'extra cost' incurred when they provide audit services and non-audit services separately. Auditors will be able to reduce their operation costs when both audit and NAS are provided jointly (Alles et al., 2005), where separating auditing and NAS results in duplication of work and leads to a greater societal costs.

In spite of the insufficient evidence about the effect of NAS on auditor independence, the MIA By-Laws still restrict most of the non-audit services provided by incumbent auditor, giving us an overview about the concern of the regulators on the issue of auditor independence and the provision of NAS as being expressed by Bogle (2005) that "sometimes, statistics cannot

prove what common sense makes obvious”. While from the perspective of financial statement’s users, they opined that the provision of NAS has a negative effect on auditor independence (Higgs & Skantz, 2006; Mishra et al., 2005). On the other hand, a study by Ghosh et al. (2009) showed that there is no proof on the relation between perceived auditor independence and NAS.

DeFond and Zhang (2014) concluded that most studies examined the relationship of NAS and audit quality which fail to find a concrete evidence in proving that the provision of NAS actually gives negative effects to audit quality as well as auditor independence (Chung & Kallapur, 2003). A study by Reynolds et al. (2004) at first detected a significant positive association between fees for NAS and audit quality; however, this result was limited to certain types of firms like firms that have initial public offerings. After including this item as a controlling variable, the result showed there is no evidence that associates NAS fees can impair audit quality. Furthermore, based on the previous study by Knechel et al. (2012), the issue of NAS impairing audit quality does not rise as a serious concern but on the other hand, it shows that it is associated with improving the overall audit quality. Based on that, we can propose that the provision of NAS may not impair auditor independence, but it actually improves the ability and competency of the auditor.

However, while most studies do not support a negative impact of NAS fees on auditor independence as well as audit quality, some counter arguments also exist. Previous studies (Larcker & Richardson, 2004; Srinidhi & Gul, 2007) remarked a negative and significant relationship between the provision of NAS and audit quality which suggested that the auditor may impair his/her independence. In addition, a study by Ferguson et al. (2004) detected a positive association between the provision of NAS to audit clients and earnings management, therefore, it can be concluded that the auditors are less likely to be independent. With reference to the above arguments, it is posited that:

H: There is a significant relationship between non-audit services and auditor independence among listed construction companies in Malaysia.

3. Methodology

This study focused on the financial year of 2017 to 2019. The period was selected because it represented the latest data available which might capture the real and current situation of auditor independence issues faced in Malaysia recently. The sample comprised of listed construction companies in the main board of Bursa Malaysia. There were about 162 companies listed on the main market of Bursa Malaysia between the years 2017 to 2019, and only complete data were considered in the analysis. In this study, we excluded companies in which their annual reports were unobtainable or had missing information. After excluding those criteria in our sample, the data only comprised of 147 companies (refer Table 1; information on data selection procedure).

Table 1: Sample Selection Procedures

Annual Report of Construction Companies between 2017-2019	162
Minus: Incomplete data for the period between 2017-2019	15
Complete data for the period between 2017-2019	147

The dependent variable for this study is auditor independence. To measure auditor independence, we used audit opinion as a proxy to auditor independence. We chose to use audit opinion as a proxy to auditor independence since it is the most direct method of assessing auditor independence. Thus, in order to assess auditor independence, we need to look at the ability and the will of external auditors in forming qualified reports in the presence of factors, such as the provision of non-audit services provided on the construction companies listed in Bursa Malaysia. Hence, the study applied dichotomous variables which take the value of 1 for qualified audit report and 0 for otherwise (unqualified report).

Following Paterson and Valencia (2011), Srinidhi and Gul (2007), Krishnan and Yu (2011), this study applied natural log of NAS as a measurement for NAS. This method of measurement will be able to capture the level of economic bonding resulting from the purchase of NAS. To test the hypothesis, this study adopted the previous models (Li, Hay, & Knechel,

2005; Garcia-Blandon & Argilés-Bosch, 2016) of probit model that focused on construction companies in Malaysia. Table 2 provides information on variable definition. Below is the model:

$$AO = b_0 + b_1NAS + b_2LEV + b_3LOSS + b_4CI + b_5BIG4 + b_6LAF + b_7AC_IND + b_8FF + b_9AE + e$$

Table 2: Definition of Variables

#	Variables	Sign	Definition	Source
Panel A : Dependent variable				
1.	OPINION (AO)		An indicator variable 1 for qualified opinion, 0 otherwise	Annual reports
Panel B : Independent Variables				
1.	NAS	-	Natural log of non-audit services	Annual reports
Panel C : Control Variables (financial)				
1.	LEV		Financial leverage, measured as the ratio of total debt to total assets of the firm	Annual reports
2.	LOSS		Firm reporting loss in the previous year	Annual reports
3.	CI		Firm capital intensity ratio, measured as the ratio of gross value of property, plant and equipment of firm to total assets of the firm	Annual reports
4.	LAF		Natural log of audit fee	Annual reports
Panel D : Control Variables (Corporate Governance)				
1.	BIG4		The incumbent auditor is either from Big 4 firms or otherwise.	Annual reports
2.	AC_IND			Annual reports
Panel E : Control Variables (Institutional Variables)				
1.	FF		The number family members on board	Annual reports
2.	AE		Percentage of Malay auditor in the industry	Annual reports

4. Results and Discussion

4.1 Descriptive analysis

Table 3 presents the descriptive statistics for the dependent variable (Panel A), independent variables (Panel B), financial variables (Panel C), corporate governance variables (Panel D), and institutional variables (Panel E). AO in Panel data A represents the audit opinion as a proxy of auditor independence that applies dichotomous variable by the value of 1 which represents a qualified report and 0 for unqualified report. The mean for AO presents the average of 5.4 percent from the whole sample of 147 companies, showing that the numbers of qualified reports in the construction industry is low. This number might indicate either in the construction industry that companies might present a good accounting practice and present a true and fair views in their reporting, or auditor has impaired their independence and failed to give their professional judgment through qualified opinions.

Panel data B presents an independent variables, non-audit services (NAS). NAS is measured by the natural log of NAS. The mean for non-audit services to the ratio of total fees is 15.7 percent which indicates that the average of non-audit fees paid to auditors in construction industry in Malaysia is 15.7 percent from the total fees paid to auditor. The minimum percentage of non-audit fees paid to auditor is 1 percent and the maximum non-audit fees paid is 95 percent from the total fees. Compared to previous study by Abdul Wahab et al. (2019), using the whole population of data from Bursa Malaysia, the average non-audit fees paid by companies is 17.9 percent from the total fees paid, therefore this study on construction companies mapped the whole population.

Table 3: Descriptive Analysis of the Variables in Construction Companies between Years 2017-2019

Variable	Mean	Maximum	Minimum	Std. Dev.	Observations
PANEL A: Dependent Variable					
AO	0.054	1.000	0.000	0.228	147.000
PANEL B: Independent Variable					
NAS	0.157	0.950	0.010	0.166	147.000
LOGNAS	10.223	15.854	6.957	1.507	147.000
NAS_RM	127809.700	7678000.000	1050.000	647102.400	147.000
PANEL DATA C: Control Variable (Financial)					
LEV	0.528	0.950	0.000	0.207	147.000
LOSS	0.177	1.000	0.000	0.383	147.000
CI	0.095	0.410	0.000	0.089	147.000
AF	363079.300	4174000.000	12000.000	508909.700	147.000
LAF	12.419	15.244	9.393	0.829	147.000
PANEL DATA D: Control Variable (Corporate Governance)					
AC_IND	0.926	1.000	0.500	0.134	147.000
BIG4	0.272	1.000	0.000	0.447	147.000
PANEL DATA E: Control Variable (Institutional Variable)					
FF	0.510	1.000	0.000	0.502	147.000
AE	0.061	1.000	0.000	0.241	147.000

4.2 Correlation

Table 4 explains the correlation between the variable using the Pearson method. The NAS exhibits a significant positive relationship with audit opinion (NAS and AO) at 10 percent level or 0.1 (0.08). It indicates that the level of auditor independence increased when the ratio of non-audit fees to total fees was increased. The preliminary result of possible relation between non-audit services and auditor independence contrasted the expectation of a negative relationship in which the non-audit services impair auditor independence (Che Ahmad et al., 2006; Srinidhi & Gul, 2007; Krishnan et al., 2011). A possible explanation of this result might be the argument regarding knowledge spillover (Krishnan & Yu, 2011; Knechel & Sharma, 2012; Abdul Wahab et al., 2014). A provision of non-audit services to the client is argued to be not impairing auditor independence; however, it is helping the auditor in forms of knowledge spillover and eases the audit process (Krishnan & Yu, 2011; Knechel & Sharma, 2012; Abdul Wahab et al., 2014).

Table 4: Correlation Analysis of the Variables

Probability	AO	NASRATIO	NAS	DE	LEV	LOSS	CI	AC_IND	BIG4	LAF	FF	AE
AO	1.000											

NASRATIO	0.080	1.000										
	0.334	----										
NAS	0.117	0.759	1.000									
	0.158	0.000	----									
LEV	0.275	-0.130	0.155	0.134	1.000							
	0.001	0.118	0.061	0.107	----							
LOSS	0.125	0.121	0.135	0.109	0.084	1.000						
	0.133	0.144	0.104	0.190	0.313	----						
CI	-0.061	-0.051	-0.025	0.022	-0.074	-0.055	1.000					
	0.462	0.543	0.766	0.794	0.376	0.509	----					
AC_IND	-0.128	-0.009	-0.057	-0.199	0.002	-0.041	-0.024	1.000				
	0.122	0.914	0.496	0.016	0.985	0.624	0.776	----				
BIG4	0.055	0.159	0.330	-0.067	-0.005	0.117	0.224	-0.226	1.000			
	0.505	0.054	0.000	0.421	0.948	0.158	0.007	0.006	----			
LAF	0.033	-0.152	0.405	-0.012	0.406	0.147	0.088	0.017	0.297	1.000		
	0.693	0.066	0.000	0.886	0.000	0.076	0.291	0.841	0.000	----		
FF	-0.005	0.047	-0.035	-0.141	-0.030	-0.223	0.179	-0.096	0.140	-0.090	1.000	
	0.953	0.573	0.678	0.089	0.723	0.007	0.030	0.250	0.090	0.277	----	
AE	0.189	-0.032	-0.078	0.409	0.150	-0.044	-0.002	-0.211	0.035	-0.022	-0.090	1.000
	0.022	0.703	0.349	0.000	0.069	0.597	0.980	0.010	0.673	0.792	0.276	----

Notes: Where AO is the audit opinion which is measured as an indicator variable 1 for qualified opinion, 0 otherwise. NAS is the natural log of non-audit services. LEV is the total liability deflated by total assets. LOSS is the previous loss which is measured by firm reporting loss in the previous year. CI is the firm capital intensity ratio, measured as the ratio of gross value of PPE and equipment of firm to total assets of the firm. AC_IND is the audit committee independence which is measured as percentage of audit committee independence in a firm. FF is the family firm, take the value of the number family members on the board. BIG4 is an indicator variable that takes the value of '1' if the auditor is big 4 auditor, '0' otherwise. LAF is the natural log of audit fees. AE is the auditor ethnicity which is measured percentage of Malay auditor in the industry. *, **, *** denote significant at the 10%, 5% and 1% level respectively. Based on one-tailed tests for signed prediction, two-tailed test otherwise.

4.3 Regression

Prior research provided inconclusive and mixed evidence regarding the effect of non-audit services to auditor independence. It can either impair auditor independence (Che Ahmad et al., 2006; Srinidhi & Gul, 2007; Krishnan et al., 2011) or benefit the auditor in the form of knowledge spillover (Krishnan & Yu, 2011; Knechel & Sharma, 2012; Abdul Wahab et al., 2014). The result from the regression analysis on the relationship between non-audit services and the proxy of auditor independence (audit opinion) showed that it is positively significant at 10 percent level of significant or 0.1 in which the z-stat is 1.856 and the probability is 0.063, thus support the H2 on this study where there is a significant relationship between non-audit services and auditor independence among listed construction companies in Malaysia. This study argues that non-audit services might not harm auditor independence due to knowledge spillover which is developed during the services provided which supported previous studies (Krishnan & Yu, 2011; Knechel & Sharma, 2012; Abdul Wahab et al., 2014). The auditor will be benefited with the services provided and be more familiar to the company's activity, operation and environment which make it easier to conduct their audit process. Non-audit services are also argued to reduce audit report lag affecting from knowledge spillover (Krishnan & Yu, 2011; Knechel & Sharma, 2012; Abdul Wahab et al., 2014) and not impairing auditor independence.

The regression analysis conducted on this study found that the relationship between control variable of LEV and dependent variable of AO has a significant positive relationship at 5 percent level of significant or 0.05 where the z-stat is 2.33 and the probability is 0.02. Besides, the control variable of LOGAF also shows a significant negative relationship at 10 percent level of significant or 0.1 where the z-stat is -1.673 and the probability is 0.094. The other control variables such as LOSS, CI, AC-IND, FF, BIG4, and AE are not significant where the p-value is more than alpha value at 10 percent level of significant ($p > 0.10$), providing no evidence of association between the variables and auditor independence. Overall, there is no problem of multicollinearity between the variables since the variance inflation factor (VIF) is 1.828 which is less than 10 (refer Table 5).

Table 5: Regression Analysis

Dependent Variable: AO					
Variable	Coefficient	Standard Error	z-Stat	Probability	
Constant	-0.595	5.883	-0.101	0.920	
NAS	0.477	0.257	1.856	0.063	*
LEV	4.293	1.843	2.330	0.020	**
LOSS	0.120	0.757	0.159	0.874	
CI	0.094	2.782	0.034	0.973	
BIG4	0.102	0.645	0.158	0.874	
LAF	-0.861	0.514	-1.673	0.094	*
AC_IND	0.127	1.745	0.073	0.942	
FF	0.105	0.598	0.176	0.861	
AE	0.222	0.840	0.265	0.791	
McFadden R-squared	0.471				
Prob(LR Stat)	0.001				
VIF	1.828				

Notes: Where AO is the audit opinion which is measured as an indicator variable 1 for qualified opinion, 0 otherwise. NAS is the natural log of non-audit services. LEV is the total liability deflated by total assets. LOSS is the previous loss which is measured by firm reporting loss in the previous year. CI is the firm capital intensity ratio, measured as the ratio of gross value of PPE and equipment of firm to total assets of the firm. AC_IND is the audit committee independence which is measured as percentage of audit committee independence in a firm. FF is the family firm, take the value of the number family members on the board. BIG4 is an indicator variable that takes the value of '1' if the auditor is big 4 auditor, '0' otherwise. LAF is the natural log of audit fees. AE is the auditor ethnicity which is measured percentage of Malay auditor in the industry. *, **, *** denote significant at the 10%, 5% and 1% level respectively. Based on one-tailed tests for signed prediction, two-tailed test otherwise.

5. Conclusion

The provision of non-audit services as well as the enforcement of good corporate governance has become a serious concern among regulators as well as practitioners and academicians arguing about the pros and cons of those issues. However, despite of the continuous discussion in the literature, the MIA By-Laws has restricted some of the NAS that can be practiced and offered by auditors to their clients, and the government has also put some good work by keep improving and revising the regulation and guidelines for the corporate world which can be highlighted in the newly revised Malaysian Code of Corporate Governance (MCCG) in 2017. Many studies were conducted in the field to provide a solid justification on their points of argument whether non-audit services give a positive or negative impact to the auditor independence, and this research also tends to give an additional evidence on the current debate.

This study will contribute to the institutions and practitioners in understanding and setting the regulation as well as strengthening the current rules and regulation on the provision of non-audit services in their engagement. Besides, this study will also help to dig information and evidence to broaden the views and understand on the construction industry in Malaysia for revising the rules and regulation in the future. For theoretical aspect, this study will contribute to the literatures by filling the gap and adding a crucial evidence on the discussion of auditor independence, especially those that relate to the construction companies in Malaysia which are currently scarce.

The result reported in this study has further improved the evidence regarding the relationship between non-audit services and auditor opinion and has strengthened the argument regarding the benefits of non-audit services to the auditor and knowledge spillover gained during the engagement. This study has time constrain which only observes through the period of three years and also limited to only one industry. Suggestion for future research is to cater more years and sample that can present the whole industries in Malaysia. Large data are more generalizable and the result are more empirically proven. Besides, the opportunity to be explored in the future is the study of auditor independence using other proxies such as financial restatement earning management.

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