Abstract: The determinants of perceived auditor independence were identified for financially distressed companies in Malaysia. These determinants included country-specific variables such as ethnicity – specifically, of the external auditor, directors, and majority shareholders - and political connection. A survey captured the perceptions of practitioners registered with the Malaysian Institute of Accountants and the data was factor analyzed. The focus on financially distressed companies and the inclusion of country-specific variables resulted in a different combination of determinants from existing auditor independence literature.

1. Introduction

Auditor independence is a topic of important concern to many stakeholders in the corporate environment (Adelopo, 2016). External auditors play an important role in the business community when performing an audit for a client. The role of an external auditor is to verify a company’s financial statements and to act in the public interest (Companies Act, 2016 Section 266 Powers and duties of auditors; Malaysian Institute of Accountants (MIA) By-Laws (Revised 2011), Section 100.2). The external auditor can act diligently when providing professional services of auditing financial statements if he or she exercises professional competence and due care (MIA By-Laws (Revised 2011) Section 130 Professional competence and due care).

Auditor independence establishes and maintains the credibility of the auditing profession. It also instills confidence in the investing community and society regarding the work of audit professionals. If auditor independence is impaired, the reputation of the external auditor could be placed in jeopardy due to legal actions taken by regulatory bodies against the external auditor and decrease confidence in audit reports issued by external auditor.

2. Auditing Profession

The auditing profession performs a critical role in giving reasonable assurance of the reliability and credibility of a firms’ financial statements to the public and users’ of financial statements, specifically investors and creditors. However, lately, the profession appears to have been in a state of rapid change (e.g. Knechel & Vanstraelen, 2007; Lombardi, Bloch, & Vascular, 2014). According to Knechel & Vanstraelen (2007), “there is now little doubt that the past few years have been an increase in expectations from auditing and auditors”.

The credibility of the auditor was badly affected as a consequence of the Enron scandal which culminated in 2001 (and was rapidly followed by WorldCom and others in the United States, and a little later by Ahold and Parmalat in Europe). These scandals have raised questions about auditor independence. The subsequent collapse of Arthur Andersen, one of the Big 5 audit firms, was an event that separated periods of time for the profession. The ‘post-Enron era’ is marked by an increase in the accounting and auditing rules and regulations (such as the Sarbanes-Oxley Act in the United Sates and the “Statutory Audit Directive” in the EU), as well as increased pressures from clients, stakeholders, regulators, and the public. Humphrey, Loft, & Wood (2009) comment that in recent years, auditors “have been placed more firmly in the public spotlight” and are subject to, for example, official investigations and questionings about their work.

In fulfilling their professional role, auditors should adhere to several principles. One of the most important principles is independence. When auditors are perceived to be independent, auditors’ opinions
on financial statements will be perceived as credible by financial statement users.

External auditors are required to report to shareholders on whether the company's accounts have been prepared: (1) to provide a true and fair view of the company's accounts; (2) to provide a true and fair view of the company's affairs; and (3) in accordance with the applicable approved accounting standards (Companies Act 2016 Section 266 Powers and duties of auditors). An audit of financial statements enhances the credibility and reliability of the financial statements by providing users of audited financial statements with reasonable assurance that audited financial reports are free from material misstatements or omissions (ISA 700 Forming an opinion and reporting on financial statements Paragraph 11). The reliance of users on audited financial statements requires the audit opinion to be based on an objective and unbiased viewpoint (MIA By-Laws, Section 120 Objectivity; AI 200 Objective and general principles governing an audit of financial statements paragraph 4).

3. Perceived Auditor Independence

The standards of auditing profession identify two types of independence that must be maintained by auditors which are independence in fact and independence in appearance. Independence, in fact, refers to the decisions that should be made objectively without influence from other parties or factors. The second type of independence is that the auditor is perceived to be independent (Stamp, E., and Moonitz, 1982). This is independence in appearance which relates to the perceived independence of auditors by other parties. Any threats to audit independence may undermine the confidence and quality of the financial statements.

In other words, perceived auditor independence refers to the perceptions of independence by financial statement users and whether, despite the (necessary) relationship with the client, other parties perceive that the auditor is able to exercise impartial judgments and resist pressure from clients (Richard, 2006).

A majority of the literature on auditor independence suggests that the credibility of financial statements depends on the perceived independence of the external auditor by the users of the financial statements (Dykyhooorn & Sinning, 1982; Firth, 1980; Lavin, 1976). For example, Firth (1980) argues that if the auditor is not seen as independent, users will have less confidence in the financial statements and the auditor’s opinion on the company’s financial statements will be of no value. Thus, the credibility of auditors depends on the perception of independence in the maintenance of public confidence (Pany & Reckers, 1980). This leads to why the Perceived Auditor Independence Index is important to be developed.

4. Auditor-Client Relationships

This is a relationship between auditor and client where a close relationship could impair auditor independence and damage the fundamental principles of an effective agency relationship. The literature on the auditor-client relationship is extensive; thus, it is usually divided based on Firth’s (1980) classifications of contributors to a close auditor-client relationship – namely, fees, conflicts of interest, personal relationships, and financial involvement with, or in the affairs of clients.

This thesis classifies the auditor-client relationship as auditor and audit-related, firm-specific, audit committee, reporting and disclosure, and financial performance. However, it is important to note that this thesis does not claim to provide an exhaustive review of the literature on auditor independence.

When considering the issues related to auditor independence, it should be remembered that the term ‘auditor’ can have several meanings. It can refer to the individual audit partner, the local audit office, and the national audit firm. This paper examines the issues in the auditor-client relationships at the audit partner level.

5. Auditor Independence Variables

Auditor independence has been the subject of research over the years (Baker, 2005). A large number of previous researches on auditor independence have investigated the effect of variables such as audit fees, audit tenure, Big 4 or non-Big 4 audit firm, and audit committee factors on user perceptions of auditor independence (Jensen & Payne, 2005, 2003; Barlett, 1993; Beattie et al., 1999; Teoh & Lim, 1996). These variables can either impair or enhance auditor independence (Buchan, 2005; Lowe & Pany, 1995). Variables discussed in literature categorised as: (1) Auditor and Audit-related, (2) Client, (3) Audit Committee, (4) Reporting/Disclosures, and (5) Financial Performance.

5.1. Auditor and Audit-related

The five factors of Auditor and Audit-related are: (1) Non-audit Services; (2) Fee Dependency; (3) Auditor Ethnicity; (4) Auditor Tenure; and (5) Audit Firm Size.
Previous research has found that providing both audit services and NAS will impair auditor independence (Adeyemi & Olowookere, 2012; Ahadiat, 2011; Campa & Donnelly, 2016; M. DeFond & Zhang, 2014; Quick & Warming-Rasmussen, 2015). However, Ratzinger-Sakel (2013) results do not suggest that German auditors are less independent when the level of non-audit fees is high. Where else, Read (2015) studied publicly held US companies and Zhang, Hay, & Holm (2016) examines Norwegian audit market which shows that there is no relationship between NAS and perceived auditor independence.

A number of empirical studies has investigated the influence that client importance has on perceived auditor independence (e.g. Beattie et al., 1999; Alleyne et al., 2006; Al-Ajmi and Saudagar, 2011; Dart, 2011). Client importance is defined by these studies as fees collected from the audit client. When a client contributes a high percentage of the audit firm’s annual total fees, i.e. there is high economic dependence on that client, sophisticated users of financial statement perceive that auditor independence is impaired (Beattie et al., 1999; Firth, 1980; Gul, 1991; Teoh & Lim, 1996).

Jensen & Yiu (1995) reported that financial reporting and auditing behaviour may be influenced by a country’s culture. Auditor objectivity and judgement can be potentially influenced by an ethnic kinship and obligation, especially when there is perceived threat from other ethnicities. At an extreme end of the spectrum, there could be a potential conflict of interest when both the auditor and client are of the same ethnicity (Jensen & Yiu, 1995) which could lead to the impairment of auditor independence.

An audit firm’s tenure is defined as the duration the auditor spends in meeting a client’s audit needs. Studies have reported that long durations of auditor tenure impair auditor independence (Alleyne, Devonish, & Alleyne, 2006; Beattie et al., 1999; Firth, 1980; Shockley, 1981). However, Dart (2011) reported majority of UK investors disagreed that long-term audit tenure is a threat to auditor independence.

Larger audit firms are perceived to be more independent than their smaller counterparts. As such, audit reports by larger audit firms were perceived to be more reliable. Kaplan & Williams (2013) reported Big N firms were less likely to issue going concern opinions to financially distressed clients. Li, Masli, Xu, & Xu (2015) also found that auditors were less likely to issue going concern audit opinions when investor sentiment was high.

5.2. Client Characteristics

Client comprises five variables: (1) Director Ethnicity; (2) Board Independence; (3) Shareholder Majority; (4) Ownership Structure; and (5) Client Size.

Effiezal Aswadi et al. (2011) reported that the percentage of Bumiputera directors on the board has significantly influenced the relationship between non-audit fees and audit fees. This suggests that the presence of Bumiputera directors could impair auditor independence. In addition, the study had identified a negative relationship between the proportions of Bumiputera directors with the issuance of modified audit opinions after analysing 379 clients from 2001 to 2003.

Board independence refers to the proportion of independent non-executive directors on the board of directors relative to the total number of directors. Fama and Jensen (1983) argue that executive management is provided access to information that can result in them being the most influential board members. However, Williamson (1984) noted that the presence of executive management on the board can result in the board becoming subject to executive management’s demands. Therefore, the independence of the board is compromised.

Malaysian studies reports that Bumiputera-controlled firms are ethnically favoured firms that are often politically connected firms. Furthermore, they are often perceived to entail poor corporate governance practices, be more risky, and have greater agency problems (Abdul Wahab et al., 2009; Chan et al., 2006; Gul, 2006; Johnson and Mitton, 2003). Therefore, these studies suggest that Bumiputera-controlled companies impair auditor independence.

Studies investigating ownership structure, political connection and auditor independence in China (See Chan et al., 2006; Gul et al., 2007; Yang, Tang, Kilgore, & Yi Hong, 2001) examined whether a strong government-auditor relationship had the ability to result in compromised auditor independence.

The visibility of larger clients increases this reputation risk. Second, when the client’s firm size increases, the potential litigation costs also rises (Reynolds & Francis, 2001). Comparatively, clients of considerable size and financial resources would enhance the rigor and professionalism of audits rather than constitute a source of pressure that could jeopardise the independence of auditors (Blay & Geiger, 2012; Chan Li, 2009). In summary, past
studies suggest that the impact of larger clients on auditor independence is mixed.

5.3. Audit Committee

The Audit Committee studied are: (1) Audit Committee Expertise; (2) Audit Committee Size; and (3) Audit Committee Activity.

Abbott, Parker, Peters, & Raghunandan (2003) documented that the presence of a member of a board with financial expertise had the effect of significantly reducing the incidences of financial statement restatements. Franzel (2014) supported that the accounting expertise of audit committee members contributed to the maintenance of auditor independence.

Lin, Li, & Yang (2006) reported that larger audit committees reduce earnings restatement. When audit committee size increases, there is lower propensity for management to influence a significant number of audit committee members. In terms of the ideal audit committee size, the Hampel Report (1998) proposes a minimum of three non-executive directors for the audit committee to be effective.

Zulkarnain, Shamsher, & Karbhari (2009) reported that the perceived auditor independence is safeguarded when the audit committee is active. An active audit committee served as a safeguard for good financial reporting. Therefore, an audit committee that meets more than the minimum requirement is deemed as being more committed and is perceived to have high auditor independence.

5.4. Reporting/Disclosure

Reporting/disclosure consist of five variables: (1) Accounting Restatements; (2) Detailed NAS Disclosure; (3) Credit Rating Disclosure; (4) Whistle Blowing Policy Disclosure; and (5) Material Level Disclosure.

Eilifsen and Messier (2000) and Young, Tsai, & Hsu (2008) found that a restatement shows auditor independence because they are willing to disclose the issue through restatements.

Al-ajmi & Saudagar (2011) reports that when information about the detailed NAS is disclosed perceptions of auditor independence are affected.

Feldmann & Read's (2013) study that examined the credit ratings and audit opinions of distressed companies before they file for bankruptcy and found that the significance for the issuance of GCO when the credit ratings are poor. This indicates credit rating disclosure enhance perceived auditor independence.

A study by PwC (2014) reported that the implementation of whistle-blowing has improved financial reports from undue influence from external parties. Moreover, whistle blower policy is now mandatory and has been modified to align with the provisions of Companies Act 2016. Brennan & Kelly (2007) found that where firms have adequate formal structures for reporting wrongdoing, trainee auditors are more likely to report wrongdoings and have greater confidence that this will not adversely affect their careers.

A material threshold is commonly stated as the percentage of net profit below which an item is not material; hence, it is not separately disclosed in the financial statements. It is material above this percentage; hence, it is separately disclosed in the financial statements (Iskandar 1996). Disclosing the material threshold in the annual report, it shows that a company’s financial statement is prepared in a transparent manner which will enhance auditor independence.

5.5. Financial Performance

Six financial statement variables were selected to represent financial performance: (1) Current Ratio; (2) Debt Ratio; (3) Receivables Ratio; (4) Growth Ratio; (5) Inventory Ratio; and (6) Recurring Operating Loss.

The current ratio measures the company’s ability to repay its debt within the next 12 months or its business cycle. This ratio is computed as current assets divided by current liabilities. The debt ratio reflects the company’s leverage and is reflective of the company’s long-term solvency. This ratio divides total liabilities (i.e. debt) by shareholders’ equity to indicate how a company’s assets are financed. The Receivables ratio, Growth ratio, and Inventory ratio collectively capture a company’s operating efficiencies and accounting complexity that might expose the company to greater risks (Ashbaugh-Skaife, Collins, & Kinney, 2007; Francis & Stokes, 1986; Kinney & McDaniel, 1989).

Kaplan & Williams (2012) define financial distress as having negative retained earnings and two consecutive years of losses. Furthermore, long-term operating companies recurring losses could indicate a ‘sick’ company. Thus, the ability of a company to finance its operations and continue operations into the foreseeable future (Levitan & Knoblett, 1985) is questioned. As such, an auditor will be more likely to issue going concern audit opinion when recurring
operating losses occur and it enhances auditor independence.

6. Determinants of Perceived Auditor Independence

A survey was developed and administered to practitioners registered with the Malaysian Institute of Accountants (MIA) with the aim of capturing their perceptions of auditor independence in the context of financially distressed companies. They were selected because they are able to assess the level of threats for each indicator and scenario given in the survey. Forty-one indicators of auditor independence were initially identified from literature. They were regrouped into five new determinants, namely: (1) Disclosure and Financial Performance (DISFIN); (2) Ethnicity (ETHNY); (3) Relationship-centric (RSHIP); (4) Assurance Focus (ASSRE); and (5) Transparency Focus (TRANS).

Table 1. Perceived Auditor Independence Indicators

<table>
<thead>
<tr>
<th>Measure In Survey</th>
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<tbody>
<tr>
<td>DISFIN Disclosure And Financial Performance</td>
<td></td>
</tr>
<tr>
<td>D4 Whistle Blowing policy is disclosed Annual Report</td>
<td>0.868</td>
</tr>
<tr>
<td>C7 Audit committee has conducted more than 4 meetings per year</td>
<td>0.824</td>
</tr>
<tr>
<td>E6 Aggregate income of two consecutive years is less than zero</td>
<td>0.810</td>
</tr>
<tr>
<td>D1 Financial statementshave accounting restatements</td>
<td>0.715</td>
</tr>
<tr>
<td>E4 Growth ratio is low</td>
<td>0.711</td>
</tr>
<tr>
<td>D3 Credit Rating is disclosed in Annual Report</td>
<td>0.698</td>
</tr>
<tr>
<td>E1 Current ratio is low</td>
<td>0.676</td>
</tr>
<tr>
<td>E2 Debt ratio is high</td>
<td>0.633</td>
</tr>
<tr>
<td>E5 Inventory is low</td>
<td>0.629</td>
</tr>
<tr>
<td>ETHNY Ethnicity</td>
<td></td>
</tr>
<tr>
<td>B2 Bumiputera directors represent 50% to 99% of the Board of Directors</td>
<td>0.911</td>
</tr>
<tr>
<td>B1 Bumiputera directors represent 100% of the Board of Directors</td>
<td>0.907</td>
</tr>
<tr>
<td>B6 Majority of the company’s shareholders are Bumiputera</td>
<td>0.863</td>
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<tr>
<td>A5 Auditor Ethnicity being a Bumiputera</td>
<td>0.779</td>
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<tr>
<td>C2 Audit committee has 1 financial expert</td>
<td>0.762</td>
</tr>
<tr>
<td>A8 Auditor firm tenure 2 to 3 years</td>
<td>0.602</td>
</tr>
<tr>
<td>RSHIP Relationship-centric</td>
<td></td>
</tr>
<tr>
<td>A9 Auditor firm tenure between 4 and 8 years</td>
<td>0.860</td>
</tr>
<tr>
<td>C6 Audit committee has conducted 4 meetings per year</td>
<td>0.752</td>
</tr>
<tr>
<td>B9 Director(s) have substantial shareholding</td>
<td>0.743</td>
</tr>
</tbody>
</table>

The first determinant is Disclosure and Financial Performance (DISFIN). There were 9 DISFIN indicators. These include non-financial disclosure indicators (i.e. D1, D4, and E6), audit committee disclosure indicators (i.e. C7), and financial performance indicators (i.e. D3, E1, E2, E4, and E5). All these indicators have a positive impact on perceived auditor independence.

The second determinant is Ethnicity (ETHNY) which has six indicators. Four of the six indicators focused on the ethnicity of the board of directors (i.e. B1 and B2), the ethnicity of the majority of the shareholders (i.e. B6), and the ethnicity of the auditor (i.e. A5). Ethnicity is an additional variable to Malaysia. Two other indicators that loaded strongly on this determinant are: (1) there is at least one financial expert on the audit committee (i.e. C2); and (2) audit firm tenure (i.e. A8). All these indicators have a positive impact on perceived auditor independence.

The third determinant is Relationship-centric (RSHIP) which comprises five indicators. A stronger relationship is indicated by a longer audit firm tenure (i.e. A9 and A10), regular audit committee meetings (i.e. C6), directors have substantial shareholding (i.e. B9) indicating the close relationship between the board and shareholders (i.e. ownership), and smaller firm size (i.e. B12). All these indicators have a positive impact on perceived auditor independence.

The fourth determinant is Assurance Focus that is composed of four indicators. Three of these indicators (i.e. A4, B4, and C1) have a positive impact on perceived auditor independence. These
indicators indicate that a low (i.e. less than 10%) economic independence between the audit firm and client, more (i.e. between 33% and 50%) independent board directors, and more than the minimum of one financial expert on the audit committee enhance perceived auditor independence. Comparatively, when the provision of non-audit fees is more than 20% of audit fees (i.e. A1), perceived auditor independence decreases.

The fifth determinant is Transparency Focus (TRANS) that is composed of four indicators. The results indicated that transparency is indicated by the level of material disclosure in the Annual Report (i.e. D5); disclosure of detailed breakdown of Non-Audit Service Fees (i.e. D2); and an auditor of Chinese ethnicity (i.e. A6) have a positive impact on perceived auditor independence. In contrast, political connection which is reflected by the substantial level of government shareholding in the company (i.e. B11) has a negative impact on perceived auditor independence.

The five identified determinants can be explained by Agency Theory. For example, the relation between the parties involved becomes infected if the agents take advantage of their knowledge for personal gain at the expenses of the principal’s lack of knowledge in the area which gives rise to conflicts (Arnold and Lange, 2004). By disclosing and sharing more information, it can be predicted that it can minimise the negative impact on perceived auditor independence.

7. Summary

The set of determinants provides a comprehensive overview of the variables that impact auditor independence in the specific context of financially distressed companies. A related contribution is the inclusion of Malaysia-specific variables of ethnicity and political connection. The Transparency Focus determinant included the Auditor ethnicity being a Chinese variable and the Political Connection variable, i.e. Government have substantial shareholdings. The former variable had a positive effect on the Transparency Focus determinant while the latter variable had a negative effect on the Transparency Focus determinant.

8. References


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