



## AUDIT FEES AND PROVISION FOR NAS ARE THREATS TO AUDITOR INDEPENDENCE?

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### Abstract

Auditor independence is expected to give an unbiased and honest professional opinion on the financial statements to the shareholders. Impairment of an auditor independence erodes public confidence in capital markets. Along this it will lead to an audit failure, diminish of credibility of the opinions and reports given by auditors in relation with financial audits. Our study enriches the literature by connecting between audit fees and provision for non-audit services (NAS) by examining its link on auditor independence. This study makes two contributions. First, the finding is expected to provide a guide to develop or modify the existing model of audit fee determinants in Malaysia and secondly provide suggestion for issues that may be addressed in future research on the topic.

**Keywords:** Auditors' independence; Audit fees; provision of non-audit services (NAS); Malaysia

### 1. Introduction

The auditors are expected to give an unbiased and honest professional opinion on the financial statements to the shareholders. Independence of an auditor defined as the ability to present his or her opinion about the reliability and honestly in financial statements without looking from his or her interest. In the study by Caswell and Allen (2001), auditors' independence is a basic requirement in the audit profession as well as is the base public confidence in the audit function.

The independence of auditors is important to ensure that the audit is impartial and fairness, which contributes to enhance the objectivity of the financial reporting process. Lack of independence will affect the investor confidence in audited financial statements. Thus, impairment of auditor's independent is proven by a series of high profile financial scandals which shocked the public almost every year. As consequences of these corporate failures, regulators have become the dominant players in addressing financial issues.

Since, many studies on the independence of auditors were focused in developed countries, there is only little research focuses on the determinants of auditor independent in Malaysia, hence, present study attempts to examine the relationship between audit fees, provision of non-audit services (NAS) and auditor independence in Malaysia. The primary target for this research is the external auditors.

The result of this study will help to better understand and provide recent evidence of independence of auditors and help to develop guidelines for policy users and strengthen the regulatory framework in Malaysia.

## 2. Literature Review

### 2.1 Auditor Independence

As to be independence, auditors should be able to demonstrate that there is no threat in their independence so that public user or shareholders will not doubt the auditor's objectivity (Bakar, 2005). Auditor independence is crucial to be maintained when performing audit report to provide confidence to public user and shareholder in audited financial statement. Therefore, public user and shareholder can rely on the financial statement in making decision on investment or other things, so independence of an auditor is important and must be maintain at all time (Nasution, 2013).

Based on previous studies economic reliance of auditors on their clients and the provisions of non- audit service, competition, and long tenure of audit services are considered the most important independence- threatening factors.

### 2.2 Audit Fees

Audit fee is the monetary term charged by audit firms in providing audit services to clients (Andre, 2011). In addition, audit fees are depending on the auditor's skills, degree of responsibilities, amount of time in performing their audit report (Mazrah, 2013).

Audit fee size varies based off the diversity of the company, the size of the firm and so on. Drawing inferences about audit fees can be challenging because firms have different practices and limited access to data about costs and rates. The factor size of audit fees is ranked as the least important in study of Bakar (2006). One possible explanation is that the author studied the factors influencing auditor independence from the perspective of commercial loan officers as commercial loan officers usually do not have suffix information on size of audit fees charged. On the other hand, Reckers and Stagliano (1981) explained auditors can remain independent if the fees for consulting services remain modest. Dogui et al (2014) analyzed the effects of audit fees and the clients' financial power on the basis of a qualitative analysis found majority of their respondents realized that audit fees practices could lead to a conflict of interest. Andre (2011) found that large amount of audit fees resulted in impairment of auditor independence.

In prior studies, audit fees have evident influencing auditors' independence. However, Gul et al. (2007) investigate there is no effect on audit fees towards auditor independence and suggest that high audit fees will increase independence because high audit fees will increase the investment of the audit firm's reputation capital and motivate the auditors to remain their independence.

Following by Malaysia Companies Act 2016, audit fees are required to be disclosed in the annual report. Although there is a requirement but still there is a wide gap in securing the independence. The disclosure of audit fees are intended to provide certainty to public accountants and clients that audit fee reflects the level of responsibility and risk of public accountants. Policy determination of audit fee by public accountant firm becomes one of the aspects to influence auditor independence.

Thus, the following hypotheses is proposed;

H1: There is a significant influence of audit fee on auditor independence

### 2.2 Provision of non-audit services (NAS)

Auditors provide services that are not related to auditing known as non-audit services. Auditors tend to view non-audit services as consulting services as the market becomes more competitive and non-audit services provide by auditors are more reliable and preferable (Patel, 2013).

Many previous studies highlighted that users of financial statements were willing to accept some reduction in auditor independence consequent upon the provision of NAS. As such it is found provision of non-audit services has become a key factor that influencing auditor independence (Mahdi, 2009).

Francis (2006) highlighted the possibility provision of NAS fundamentally may change the auditors' role from outside sceptical reviewer to inside adviser. This change leads to compromise auditors' ability to be independent. Thus provision of NAS resulted in impairment of auditor independence. Also, Hassen, (2016) agreed that auditor provides non-audit services to client such as management consulting, bookeeping, tax consulting that will leads to impaired the independence and reduces the quality of the financial report. However, Zhang et al (2016) which

similarly do not present evidence to support the widespread belief that provision of non-audit services might impair auditor independence.

Hence, the following hypotheses is proposed

H2: There is a significant influence of Provision of non-audit services (NAS) on auditor independence

## 2.3 Conceptualisation of Agency theory and Stakeholder Theory

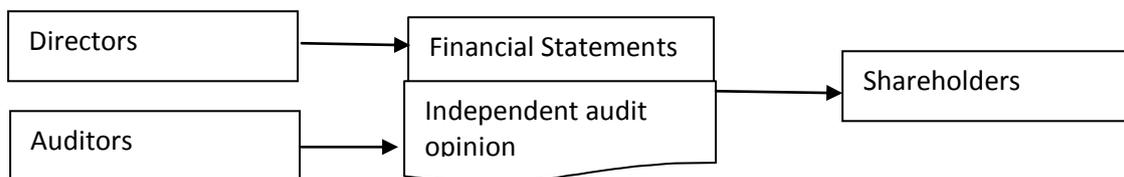
### 2.3.1 Agency Theory

Agency theory explains the objective and role of a statutory audit. The purpose of statutory audit best illustrated in Figure 1 below. The statutory audit has a vibrant purpose protected in law, which is to provide an independent opinion of auditors to the shareholders on the truth and fairness of the financial statements that are prepared by the board of directors. This elaborates relationships between principals and their agents, more prominently and develops an understanding how the statutory audit has progressed over the centuries. Under this theory, the owners (the principals) passes on all the responsibility of managing affairs of the company to directors' who act as an agents. And therefore the principal become more reliance on the agent's accounting information.

Regards to the concern about the reliability of information, any disagreement of principal and agent's objectives resulted in a potential conflict of interests between directors and shareholders in which an independent auditor is introduced and a statutory audit performed to address agency conflict between shareholders and directors.

Hence, auditor independence is vital in developing confidence in shareholders to evaluate the stewardship of directors on their skills of upbringing and managing a company. As such, present study would like to examine if this independent of auditor is being influences by audit fees and provision for NAS.

Figure 1.0: The objectives of statutory audit



Source : Adopted from <https://www.icaew.com>

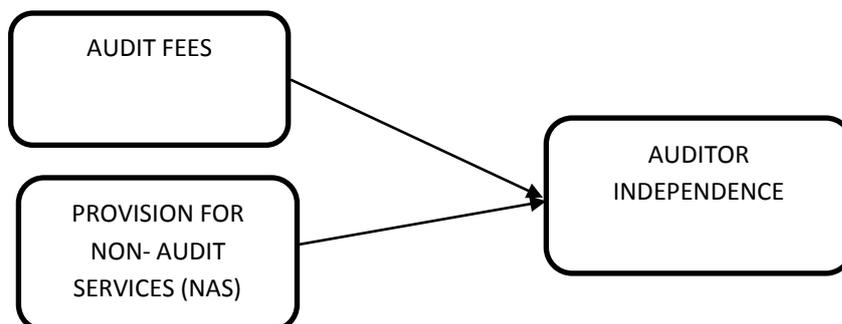
### 2.3.2 Stakeholder Theory

Audit or non-audit services being offered and charged generally will be associated indirectly to the stakeholder which was clarified as a "group that the firm needs in order to exist, specifically customers, suppliers, employees, financiers, and communities" (Dunham, Freeman, & Liedtka, 2006). Therefore, certain measures need to be consider in delivering non-audit services as well as setting large size of audit fees as it may create negative implication from an auditor independence standpoint, and that will justify whether they should provide additional assurance services (Abu Bakar et. al 2005, Xu & Wang, 2008). Those activities is perceived to be threatening the auditor in providing unbiased reporting. By emphasizing stakeholder theory, it can be turn as a motivation substance to act responsibly with regard to stakeholder interests, including fair distribution of fees, where auditor can developed a guideline for identifying unsolicited situations in which the auditor's positioning will be affected (Schnader, A.L., Bedard, J.C. & Cannon, N., 2015)

Thus, present study therefore rooted agency theory and theory of stakeholder to address its main concern if audit fess and provision of NAS influencing auditor independence in Malaysia context.

## 2.4 Proposed Conceptual Framework

Figure 2.0: Conceptual Framework



Source: Developed for the research

## 3.0 Research Methodology

Present research proposed to employ quantitative approach whereby questionnaire survey is used to capture the responses of targeted respondents. Sampling is defined as selecting a subgroup from a target population for collecting information (Daniel, 2011). Most of previous research are mainly targeting external or internal auditors as their respondents, however present study is proposed to collect data from other locations (i.e. other states in Malaysia) and from different group of respondents like auditors, bank loan officers, and financial analysts in Malaysia. A sufficiently large sample size could limit the influence of outliers and is more representative of the population (Lenth, 2001).

In present study, participants will need to express their opinion by using 5-point-Likert, scale 1 is strongly disagree to scale 5 strongly agree. The data collect from questionnaire will be covert into table, graph, and statistical analysis by using SPSS software version 24.

## 4.0 Conclusion

There is considerably less research to date, especially in a Malaysia context that has focused on the auditor independence. Therefore, the findings in study are believed to offer guidance to practitioners on ways to enhance policies and frameworks related to auditor independence can be structured to ensure adequate regulation of the capital market.

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