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## Characteristics of non-audit services and financial restatements in Malaysia

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### ABSTRACT

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

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### 1. Research aims

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

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

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

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

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The primary purpose of this study is to investigate the issue of auditor independence in Malaysia.<sup>4</sup> Joint provision of non-audit and audit services by a single auditor has been the subject of numerous studies, as such provision may undermine auditor independence as the economic bond with management increases over time (Francis, 2006). Three research objectives are offered for this study. First, we explore the relationship between non-audit fees and financial statement restatements. Second, we examine the impact of various types of non-audit services (NAS) on financial restatements. Third, we consider whether recurring or non-recurring NAS affect financial restatements. The incidence of financial restatements is used as a proxy for financial reporting and audit quality. Malaysia is an excellent choice to test auditor independence since the incumbent statutory auditor can provide NAS (unlike the U.S, for example) and this, in theory, could undermine auditor independence. Furthermore, the Malaysian audit market has not experienced regulatory reforms like those of the US Sarbanes–Oxley Act (2002), and so provides more opportunity to explore the impact of NAS on auditor independence.

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

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

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

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

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

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

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

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