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POLITICAL CONNECTIONS: A THREAT TO AUDITOR INDEPENDENCE?

ABSTRACT

This study examines whether political connections further impair auditor independence by investigating the relationship between non-audit fees and audit fees and as to whether political connections moderate such relationship. This study is conducted in Malaysia, which provides a unique institutional environment with the existence of political connections that is built on ethnic grounds. As both politically connected firms and the proportion of Bumiputras directors on the board are used as proxies for political connections and ethnicity, we find a positive and significant relationship between non-audit fees and audit fees, for which the relationship becomes weaker for Bumiputra-dominated firms. Nonetheless, the results suggest that political connections could pose a threat to auditor independence in both appearance and in mind.

Keywords: audit independence, non-audit fees, audit fees, political connections, ethnicity, Malaysia

Data availability: Data are publicly available from the sources identified in the paper.

JEL classifications: G34, G38, M41, M42

1.0 Introduction

The provision of non-audit services by auditors to their audit clients has long been viewed as a threat to auditor independence, and, consequently, received greater attention by professional bodies and regulators in the United States, United Kingdom, Australia and other countries. Furthermore, following the spate of major corporate failures worldwide, the issue of whether the provision of non-audit services undermined auditor independence continues to persist. An even more disturbing observation in Malaysia is the accounting irregularities, such as those found in various Government Linked Companies (GLC) that involved politically connected firms, namely, Transmile Group Bhd, Takaful Malaysia Bhd, Southern Bank Bhd, Megan Media Holdings Bhd and NasionCom Holdings Bhd.[1] These incidences attracted significant attention from the public and regulators regarding the importance of auditor independence.[2] The evidence indicates that auditors could play a certification role that could provide credibility to the financial statements (Fan & Wong, 2005). Although Fan and Wong's (2005) findings suggest that auditor independence remains intact, the issue is still questionable and warrants further investigation.

Furthermore, the Malaysian institutional environment is unique whereby the existence of political connections remains pronounced. Malaysia is a multi-racial society – Malays (also referred to as Bumiputras) being the dominant race, followed by Chinese, Indians and a variety of indigenous groups in East Malaysia – in which the economic environment clearly offers a unique and identifiable capital segment divided along ethnic lines (Yatim *et al*., 2006). In conjunction, two forms of political favouritism exist in Malaysia (Gomez & Jomo, 1999) in which the first two ethnic

groups play a major role in the socio-economy of the country with Bumiputras controlling the political administration, whilst the Chinese have a significant influence over the economic and business environment. In addition, Salim (2006) also suggests that not only is the racial composition in Malaysia an important element of the economic landscape, it also shaped the constitution and the democratic processes.

Moreover, the rise of politically-connected firms was mainly due to the New Economic Policy (NEP) in 1971, through which Bumiputras were given more privileges in terms of priority for government contracts, increased access to capital, opportunities to buy assets that are privatised, and other subsidies with a view to eradicate the wealth imbalance between races.[3] The government's effort to increase the participation of the Malay and other indigenous groups in the national economy has promoted the role of the Bumiputras in the capital market (Che Ahmad *et al.*, 2006).[4] However, the government strategy, such as the NEP, was heavily criticised as it encourages the free-rider problem, which created an invisible protecting umbrella for the Bumiputras (Suto, 2003), while, at the same time, undermining the development of professional managers (Tam and Tan, 2007).

In addition, East Asian economies, including that of Malaysia, are characterised by a relationship-based system as opposed to a market-based system (Rajan & Zingales, 1998). The market based system relies explicitly on contracts to protect the interests of capital suppliers and to facilitate resource allocations. In this system, the market becomes an important medium for governing contractual relationships, and transparency is a necessary condition for contract enforcement. Meanwhile, the

relationship-based system has its roots in cultural and political forces rather than explicit contracts leading to the self-governing network of close connections between banks, politicians, the government and other stakeholders, such as auditors. Thus, in a relationship-based market like Malaysia, being politically-connected gives the company an added advantage in relation to financial support and minimal adherence to rules and regulations. Malaysia, a multi-racial country, could be seen as a unique set-up for political connections since the fundamental of its capital market is based on racial grounds, and, at least, historically, this could raise several issues related to the issue of auditor independence, especially for these firms.

Particularly, in Malaysia, several studies have explored the relationship between political connections, corporate governance and audit fees (Johnson & Mitton, 2003; Chan *et al.*, 2006; Gul, 2006; Yatim *et al.* 2006; Abdul Wahab *et al.*, 2009). The general argument presented by these studies is that Bumiputras controlled firms are ethnically favoured firms, and, at the same time, these firms are also often found to be politically connected firms that are often perceived to entail poor corporate governance practices, be more risky and have greater agency problems. Consequently, the inherent risk is likely to be viewed as higher for politically connected firms, which, in turn, result in higher monitoring costs such as audit fees.

The empirical evidence provided by Gul (2006) supports the general argument that the increase in audit fees for politically connected firms is higher relative to their counterparts, especially for the period subsequent to the 1997 Asian Financial Crisis. Using a larger sample of firms from a period of 1999-2003, a recent study by Abdul Wahab *et al.* (2009) confirms the result of the earlier study by Gul (2006). In addition,

Wahab *et al.* (2009) also suggest that institutional investors in politically connected firms demand greater audit effort, which also increases the audit fees paid to the auditor.

The presence of non-audit services in politically-connected firms can also be viewed as a measure to overcome inefficiency (Johnson & Mitton, 2003). In contrast, the role of non-audit services could also assist auditors in understanding the nature of connected firms (Gul, 2006). We examine the impact of political connections on auditor independence by investigating the relationship between non-audit fees and audit fees and as to whether political connections moderate such relationship; this could be used to test independence in appearance.[5]

Consistent with prior studies (see Firth, 2002; Francis, 2006), we choose non-audit services as a proxy for auditor independence based on two broad reasons. First, Francis (2006) highlights the possibility that such services could fundamentally change the auditor's role from the perspective of outside reviewer to inside adviser, and, thus, compromise auditor independence. Second, Firth (2002) and Francis (2006) further state that the increasing fee reliance on non-audit services could also create an economic bond that compromises auditor independence. Based on these two broad suppositions, we envisage the following scenario. Politically-connected firms purchased non-audit services to improve their efficiency, and, therefore, will make the auditors play an insider role rather than an outside one. This situation is expected to undermine their independence (Francis, 2006). On the other hand, since connected firms are viewed as riskier and incur higher audit fees, the role of non-audit fees is to assist the auditor in making proper audit judgment, rather than compromising their

independence, which is better known as knowledge spillover (Simunic, 1984). Based on these competing arguments, we argue that the impact of political connections and non-audit services on auditor independence is rather ambiguous.[6]

In a cross-country study on corporate bailouts and political connections, Faccio *et al.* (2006) document that from 1997 to 2002, the number of politically connected firms in Malaysia was 81, second to the United Kingdom, which recorded 118 firms. However, in considering the size of the Malaysian capital market relative to that in the United Kingdom, the proportion of politically connected firms in Malaysia is staggeringly high. The list created by Faccio (2006), which she gathered from the paper of Johnson and Mitton (2003), defines politically connected firms as a firm connected to the then Prime Minister, Tun Mahathir Mohammad, the then deputy Prime Minister, Dato' Seri Anwar Ibrahim, and includes several notable cabinet members, such as Tun Ling Liong Sik, Tun Daim Zainuddin and Tun Ghafar Baba. The list also includes firms connected to the main three political parties that form the National Front; UMNO, MCA and MIC.[7]

Since Malaysia's capital market is largely shaped based on ethnic differences, we proposed another proxy for political connections, which is the proportion of Bumiputra directors, similar to a prior study by Gul (2006). As Bumiputras are given various rights in the Malaysian constitution and dominate much of the political policy making decisions in Malaysia, they are likely to be given preferential treatment by the ruling government. Such examination (empirically) provides a useful insight into the role of political economy. Furthermore, we attempt to fulfil the gap highlighted by Francis (2006) by including political connections as a unique institutional setting in

which the auditing contract could take place. In addition, our study capitalises the non-audit fees data available to give a better understanding on such provisions in determining auditor independence in support of Wang *et al.* (2008), who state that focusing on a particular country eliminates cross-country confounding factors and helps to obtain more detailed firm-level information about the effects of political connections. Based on the above, this study aims to contribute to the expanding strand of literature by examining whether political connections further impair auditor independence when they provide non-audit services to their audit clients.

Our examination from 379 client-year data from 2001 to 2003 suggests that the proportion of Bumiputra directors on the board significantly influences the relationship between non-audit fees and audit fees, suggesting that the presence (level) could impair auditor independence. In addition, at the univariate level, non-audit fees are significantly higher in politically-connected firms than non-connected firms. Thus, evidence suggests that political connections might impair the auditor independence for both in appearance and in mind.

The remainder of the paper is organised as follows. In Section 2, an overview of literature on political connections and auditor independence is discussed. In Section 3 a detailed discussion of the research hypotheses is provided. This, in turn, is followed by a delineation of the research method and data analysis in Section 4. Section 5 concludes this paper.

2.0 Political Connections and Auditor Independence

A prevalent institutional setting in all countries is political connections. Although the degree of connection varies from one country to another, it still presents an important element of economic environment and capital market. The common understanding is that political connections prevent good transparency (Bushman *et al*., 2004), which lowers financial reporting quality (Chaney *et al*., 2011) and information regarding probable expropriation may be hidden to disguise poor performance (Johnson and Mitton, 2003), offers leniency on enforcement on rules and regulations, easier access to debts due to collateral (Faccio, 2004), possible bailout from the government from defaults (Faccio, 2006) and favouritism for government contracts (Salim, 2006).

A review of the literature reveals that a number of prior studies have examined the relationship between political economy and their impact on the development of the capital market; specifically, the investigations have been extended to the examination on quality of accounting information (Ball *et al*., 2003; Chaney *et al*., 2009), corporate bailouts for politically-connected firms (Faccio *et al*., 2006), examination of performance of connected firms (Johnson & Mitton, 2003; Leuz & Oberholzer-Gee, 2006), political favouritism in relation to access to finance (Khawaja & Mian, 2005; Faccio 2006) and value of the political connections (Fisman, 2001). Some other studies also examine the impact of political connections on corporate and financial disclosure (Bushman *et al*., 2004), capital structure (Fraser *et al*., 2006, Bliss & Gul, 2012a, 2012b) and director remuneration (Abdul Wahab & Abdul Rahman, 2009). However, these studies, with some exception, have been criticised

for the use of cross-country level data, including a small sample size, potential endogeneity, and correlated omitted variables (Miller, 2004).

One could view political connections as problematic as they do not promote effective financial reporting and sound accounting practices and could promote unfair competition between connected firms and non-connected firms. However, among Asian countries, political connections or relationship-based economies could exist in order for some firms to remain afloat, probably to maintain the government agenda. This argument is highlighted by Gomez and Jomo (1997) on the subject of *positive discrimination* when discussing the NEP in Malaysia.

In addition to the linkage between firms and politicians, the ethnic composition is another important element that shapes the capital market and patterns of the economy (Salim, 2006). Malaysia is a multi-racial country in which the two most dominant ethnic groups, the Bumiputras and Chinese, play a major role in development of the economy, in which the Chinese have significant influence over the economic environment. As the gap between these two ethnic groups widened and created tension, which resulted in the 1969 riot, the New Economic Policy (NEP) was introduced.

The main idea is to promote Bumiputras shareholdings in the capital market. This is viewed as positive discrimination (Gomez and Jomo, 1997) but has some less desirable outcomes. Salim (2006) notes that Bumiputra firms are filled with young, inexperienced executives and the subject of directors independence among Bumiputra directors is questionable due to their connections or even position in political parties

(Gul, 2006). Hamid (2008) extends this argument by stating that Bumiputra firms outsource projects to other local contractors after winning government contracts. Hamid (2008) also argues that Bumiputra directors tend to be more open to cronyism and rent-seeking behaviour. Evidence suggests that these firms are inefficient (Johnson and Mitton, 2003) and require government intervention to remain afloat. As such, a political connection is an important element in any capital market, and, therefore, could impact the audit profession.

Prior studies (Chan *et al.*, 2006; Gul *et al.*, 2007; Wang *et al.*, 2008) suggest that political connections could compromise independence in several ways. We offer three suppositions on why political connection could affect auditor independence. The first supposition is the political interest itself as the auditor could have detected irregularities but does not report it to avoid losses and to protect public interests (Chan *et al*., 2006; Gul *et al*., 2007; Wang *et al.*, 2008).

Second, prior studies suggest the possibility of the government bailing out the failed politically connected firms (Faccio *et al*., 2006). As a result, since these politically connected firms are being bailed out without any indicator of financial distress, there is a possibility that the auditor might not be able to perform accordingly, this, in turn, could undermine their independence (Wang *et al*., 2008).

The final supposition is the economic or/and social bonding between audit partners and the board of directors of the firms. Using the 'self-serving' theory, prior studies suggest that auditors are expected to have an unconscious bias that prevents impartial audits because of close relationships and repeated interactions with client personnel

with whom auditors identify socially (Bazerman *et al*., 1997; Francis, 2006).[8] In line with the 'self-serving' theory, we argue that auditors could develop a self-serving bias towards politicians even without the interaction with them socially, as these politicians are usually in the limelight via the main stream media. For instance, the local Malaysian media discloses the list of corporate figures that are closely related to the current Prime Minister after the announcement of his appointment.[9] In fact, the impact of political connections could be more prevalent in Malaysia since the capital market is relatively small as compared to those in China, the U.S or the U.K.

The current extant literature exploring the role of political connections and auditor independence is based on the China market. Studies (Defond *et al*., 2000; Yang *et al*., 2001; Yang, 2003; Chan *et al*., 2006; Gul *et al*., 2007; Liu *et al*., 2011) examine whether the close relationship between government and auditor could compromise auditor independence. China presents a unique case since most of the listed firms opted for a local auditor (non-Big N) firms (Yang *et al.*, 2001; Chan *et al*., 2006; Gul *et al*., 2007) as their choice in order to mitigate future losses. Chan *et al*. (2006) even suggest that, due to connections, listed firms are even successful in shopping for unqualified opinion. Further, China has an institutional setting that has experienced an important reform in the accounting standards in the past decade and also experiences the deep involvement of local government in its firms. Liu *et al*. (2011) examine the effect of *guanxi* (a Chinese term for business connections based on social contacts) on audit quality in China.[10] Employing two types of *guanxi*; firm-level connections derived from state ownership and personal connections developed through management affiliations with external auditors, Liu *et al*. (2011) find that

state ownership and management affiliations with the external auditors both increase the probability of receiving a clean audit opinion in China.

Particularly, in Malaysia, a few earlier studies have examined this issue. Che Ahmad *et al*. (2006) examine 819 (512 firms purchase non-audit services) firms listed on Bursa Malaysia for year 2002.[11] They find a positive relationship between non-audit fees and audit fees, and between non-audit fees and qualified audit opinion. Muhammad Sori and Karbhari (2005) investigate the relationship between non-audit services and perceived auditor independence. Using a questionnaire sent to auditors, loan officers and senior managers, they find that auditor independence is significantly threatened when audit and non-audit services are jointly provided by the same audit engagement team. However, these studies do not take into consideration the role of non-audit fees in examining political connections and auditor independence linkage. Since politically-connected firms are perceived to be riskier and expected to have undergone a thorough examination from auditors, it is imperative to examine whether such political connections affect auditor independence.

Furthermore, in Malaysia, the Malaysian Institute of Accountants (MIA) By-Laws B-1.5: Threats to Independence, states that independence is threatened by self-interest (By-Laws B-1.6), self-review (By-Laws B-1.7), advocacy (By-Laws B-1.8), familiarity (By-Laws B-1.9) and intimidation (By-Laws B-1.10). Political relationship could pose self-interest, intimidation or familiarity threats to independence, as outlined by MIA By-Laws B-1.5.[12]

3.0 Hypotheses Development

3.1. Political connections, Non-audit fees and audit fees

The first three hypotheses examine the relationship between political connections, ethnicity, non-audit fees and audit fees. However, the discussion on the relationship between audit fees and non-audit fees needs to be established as the relationship between audit fees and non-audit fees is rather ambiguous. The belief that auditors reduce audit fees as a loss leader to obtain consulting work, thereby creating a threat to independence, would imply a negative relationship. In addition, a negative relationship might also be due to 'knowledge spillover' between the audit and non-audit services, thereby reducing the cost of audit services (Che Ahmad *et al*., 2006; Hay *et al*., 2006).

In contrast, Solomon (1990) put forward four possible arguments for the unexpected positive relationship between audit fees and non-audit fees. First, 'problematic' firms may require a greater quantity of both audit and non-audit services (Simunic, 1984). Second, Palmrose (1986) suggests that some non-audit services (e.g., information system services) relate to changes in the client's organisation, which may require additional audit effort. This is also supported by the argument by Firth (1997b) who states that company-specific events will require additional auditing and consultancy services. Third, Solomon (1990) proposes that if there were a lack of competitiveness in the market for non-audit services, this could also lead to higher fees for audits, as clients have to pay a higher price due to the monopolistic nature of non-audit services. The fourth possible explanation concerns the internal dynamics of audit firms and partner remuneration. When a client purchases audit and non-audit services, the

categorisation of fees between the two could be somewhat discretionary. For example, partners and managers may coordinate some audit time helping to explain non-audit projects to clients (Hackenbrack and Knechel, 1997). Thus, there is a possibility that the audit partners could misclassify non-audit fees within the audit fee category, creating the appearance of higher audit fees (Solomon, 1990).

Despite, the argument of the positive relationship between non-audit fees and audit fees, the results of past studies mostly support the positive relationship between non-audit fees and audit fees.. For instance, Simunic (1984), Palmrose (1986), Beck *et al*. (1988), Davis *et al*. (1993), Barkess and Simnett (1994) and Firth (2002) find a positive relation between non-audit fees and audit fees, and only Abdel-Khalik (1990) documents otherwise. In relation to the Malaysian study, consistent with most past literature, Che Ahmad *et al*. (2006) observed a positive relationship between non audit fees and audit fees.

In summary, there is a very little evidence to suggest a negative relationship between non-audit fees and audit fees, specifically evidence from Malaysia (see Che Ahmad *et al*., 2006) also support a positive relationship. As such, based on the results of past studies and the argument by Solomon (1990), we posit a positive relationship between non-audit fees and audit fees (state in alternate form):

H_1: There is a positive relationship between non-audit fees and audit fees

Similar to Gul (2006), we examine the relationship between political connections and audit fees. However, the sample for this study covers a 3-year period, 2001-2003

whereby during this period, the initiatives for corporate governance reforms have just started, for instance the Malaysian Code of Corporate Governance was first introduced in 2001. Since, the period captures the governance initiatives, it is interesting to test this relationship to further explore whether the governance reforms improved the practice or the perception of auditors towards politically connected firms. . Our argument mimics Gul (2006), that we expect a positive relationship between connected firms and audit fees since auditors perceive greater risk inherent in politically connected firms leading to auditors performing greater audit effort. Furthermore, past studies by Ball *et al*. (2003) and Bushman *et al*. (2004) indicate that politically connected firms are negatively associated with good corporate governance practice, signalling the higher agency costs inherent in such firms. In addition, these politically connected firms may have a higher probability of their business failing, and have potential to misstate their financial health in their financial statements to avoid covenant violations. Align with our argument, it is reasonable to expect that having perceived to be higher risks and lower governance practices, this could lead to these firms being charged higher fees by audit firms. . As such, we posit the following hypothesis (state in alternate form):

> *H_2: There is a positive relationship between political connections and audit fees*

In Malaysia, a steady stream of research has developed about corporate setting, where the political economy has strong effect on how firms run both externally (based on political connections) and internally (which is based on ethnicity) (See Haniffa & Cooke, 2002; Gul, 2006; Abdul Wahab et al., 2007; Johl *et al.*, 2012). These studies

have examined the level of Bumiputra and its impact with various organisational outcomes. More specifically, the emerging empirical evidence suggests significant associations between ethnicity and audit fees (see; Gul, 2006; Yatim *et al*., 2006; Johl *et al*. 2012). In particular, Johl *et al*. (2012) finds support that firms with Bumiputra CEO and fully Bumiputras- composed audit committee incur higher audit fees.

We include ethnicity as another proxy for political connections, largely due to the positive discrimination resulting from the NEP, as purported by Gomez and Jomo (1999). Salim (2006) also notes that Bumiputras tend to be more politically connected and open for possible cronyism, which could carry more inherent risk thereby resulting in higher monitoring costs and thus higher audit fees. From the supply-side perspective, the ethnicity of director is likely to have some bearing on auditor's risk assessment of the clients, this is so as it is more likely that auditors may assess a higher level of audit risk when dominant Bumiputras firms is present due to the fact that they have poorer reputation with respect to business management especially it is generally well known that Bumiputras-owned firms are poorly run and lacking in accountability and good governance(Salim, 2006; Johl *et al*., 2012).

The results of past studies, such as Gul (2006) and Johl *et al*. (2012) support the supposition that Bumiputra dominated firms pay higher audit fees. As such, consistent with past studies, and the above argument that Bumiputras dominated firms inherent higher risk, we posit the following hypothesis (state in alternate form):

H_3: There is a positive relationship between the proportion of Bumiputra directors and audit fees

The relationship between political connections and non-audit services is rather unexplored. On one hand, the non-audit services act as a vehicle to improve efficiency and thus shift the role of auditors from an outsider to insider, thereby compromising their independence, while, on the other hand, since auditors view connected firms as riskier, the presence of non-audit services acts as a tool for them to make a thorough judgment on the audit report, and will therefore not undermine their independence. From this alone, it could be seen that the relationship is rather equivocal, and that the relationship between audit fees and non-audit fees itself, as documented earlier, is rather complex.

We propose the same conjecture for firms with higher Bumiputra directors. This is because, firms with high level of Bumiputra directors could be seen as inefficient and subject to cronyism, and thus carry more inherent risk leading to higher agency costs. Similar to the above argument for H_4, we propose that non-audit fees could act as a tool to improve efficiency and also a basis for auditor to have biased judgment on the audit process, especially in the politically connected or firms that are dominated by Bumiputra, it also likely that the auditors are more incline to protect their reputation being perceived as the non-audit services provider for such firms thus they used non-audit services as the platform to improve the efficiency. Therefore, based on the above argument, we predict both hypotheses (state in alternate form):

> *H_4: The positive relationship between audit fees and non-audit fees is expected to be weaker for politically-connected firms*

H_5: The positive relationship between non-audit fees and audit fees is expected to be weaker for firms with a high level of Bumiputra directors

3.0 Research Method and Data Description

The sample covers a 3-year period, 2001-2003, for firms listed on Bursa Malaysia's main board. We have a client-year sample of 379 during the period. The data for non-audit fees and audit fees were collected manually from the annual reports. The annual reports are available from Bursa Malaysia (www.bursamalaysia.com) and Mergent Online databases. We chose this particular period for two reasons. We want the sample to be similar to the period chosen by Johnson and Mitton (2003), Gul (2006) and Faccio *et al.* (2006), and, secondly, because the disclosure of non-audit fees was made compulsory by Bursa Malaysia as part of their listing requirements by the year 2001. In addition, the period is between Malaysia's 10th and 11th General Election, which occurred in 1999 and 2004, respectively. Therefore, it reflects a period of political stability as there were no elections during the period and the smooth transition of power from Tun Mahathir Mohammad to Tun Abdullah Badawi as the new Prime Minister.[13]

In order to address the first set of hypotheses, the underlying audit fee model employed in this study captures the primary fee determinants as derived from prior audit fee research. Our dependent variable is natural log transformation of audit fees (*LAF*), consistent with most audit fees studies (e.g., Gul, 2006).[14] The audit fee model is as follows:

$$LAF_{it} = a_0 INTERCEPT_{it} + a_1 POLCON_{it} + a_2 BUMI_{it} + a_3 LNAF_{it} + a_4 POLCON*LNAF_{it} + a_5 BUMI*LNAF_{it} + a_6 LNASSETS_{it} + a_7 INSTOWN_{it} + a_8 MANOWN_{it} + a_9 SQSUBS_{it}$$

$+ a_{10}SQFOREIGN_{it} + a_{11}OPINION + a_{12}CURRENT_{it} + a_{13}LIQUID_{it} + a_{14}BIGN_{it} + a_{15}ROA_{it} + a_{16}LOSS + a_{17}DEBT_{it} + a_{18}YE_{it} + INDUSTRY_{it} + PERIOD_{it} + e_{it}$

Our variable of interests are *LNAF, POLCON*[15] and *BUMI,* which are natural log transformation for non-audit fees, a dummy variable that takes the value of 1 if the firm is politically connected and the proportion of Bumiputra directors on the board, respectively.[16] We derived our political connections list from three sources, namely Johnson and Mitton (2003), Khazanah Nasional Berhad website (www.khazanah.com.my) and Mohammad *et al.* (2006).[17] Our choice of proxy for political connections is similar to Fraser *et al*. (2006) and Gul (2006).

Generally regarded as being an important determinant for the variation of audit fees (Hay *et al*., 2006), we include the natural log transformation of total assets (*ASSETS*) to proxy for firm size. We posit a positive relationship between firm size and audit fees. Larger firms are more complex and require more audit effort, resulting in higher audit fees (Simunic, 1980; Francis, 1984).

To control for ownership structures, we include two variables, *INSTOWN* and *MANOWN,* which are institutional investors and managerial ownership, respectively. We predict a positive relationship for *INSTOWN* and a negative association for *MANOWN*.[18] We add the following variables, *SQSUBS* and *SQFOREIGN,* which are square root transformation of total and foreign subsidiaries, respectively. These variables are to control for audit complexity, and, thus, a positive relationship is predicted. Current asset items (*CURRENT*), such as account receivables and inventories, tend to be more detailed than other assets, and, as such, auditors need to spend more audit effort. Therefore, a positive relationship is predicted between

CURRENT and audit fees. Further, we control for risk by including *LIQUID*, which is current assets to current liabilities, for which a negative relationship is predicted. We control for auditor size by including *BIGN*, a dummy variable, which takes the value of 1 if the firm is audited by a Big N auditing firm.

To control for problematic firms, as suggested by Solomon (1990) and Firth (2002), we include return on assets (*ROA*); *LOSS*, which takes the value of 1 if the firm records a loss in the previous year; and *DEBT*, which is total debt over total assets. We include busy work season (*YE*), which takes the value of 1 if the year-end is December and a positive relationship is predicted. Finally, we include both industries and period fixed effects.[19]

[Table 1 about here]

3.1 Descriptive Statistics

Audit fee (*AF*) averages Ringgit Malaysia RM 424,300 and ranges from RM 1400 to RM 9.4 million. Non-audit services fee (*NAF*) averages RM 210,800 and ranges from RM 1000 to R 3.1 million. Almost half of the board of directors, at 45.5 percent are *Bumiputra* directors. Sample firms average size is RM 252.7 million with the smallest at RM 2.032 million and largest at RM 6.427 billion. *INSTOWN* and *MANOWN* have an average (median) of 13.686 (7.293) and 6.351 (0.467) percent, respectively. The highest institutional shareholding is at 90.553 while managers hold, at the maximum, 64.117 percent of total shareholdings. Sample firms average 35.491 subsidiaries with 4.841 of them domiciled in a foreign country. The mean (median) ratio of current assets to total assets (*CURRENT*) stands at 0.377 (0.341), while *LIQUID* averages 3.482. On average, the sample firms experience position return on assets (ROA) at

5.379 while leverage (*DEBT*) is, on average, 0.692. Only 6.3 percent of the sample firms experience qualified opinion; 71 percent of sample firms are audited by Big N auditors; 17.4 percent of sample firms experience a loss in the past year; and 47.8 percent of firms end their fiscal year in December.

[Table 2 about here]

4.0 Results

4.1 Univariate Analysis

Table 3 presents the correlation matrix for the continuous variables. The correlation matrix suggests a significant and positive relationship between audit fees (*LAF)* and non-audit fees *(NAF),* for both Pearson and Spearman-rank correlations. In addition, we observed a positive and significant relationship between firm size (*ASSETS*) and *LAF*. No other correlations are worth noting here.

[Table 3 about here]

Table 4 tabulates the results for the test of differences for both the mean and median between politically connected and non-politically connected firms. Our univariate analysis finds that politically connected firms purchase significantly higher non-audit services than non-connected firms. This gives preliminary support that political connections could undermine auditor independence. Further, we find politically-connected firms incurred higher audit fees, giving support to Gul's (2006) theoretical argument that connected firms are riskier, thus requiring more audit effort. From the univariate analysis, we could argue that politically-connected firms are inefficient, as

highlighted by Johnson and Mitton (2003), thus requiring assistance from auditors in terms of consultancy services.

Further analysis suggests similar findings to Faccio (2004), as politically-connected firms have higher access to finance by evidence of higher leverage (*DEBT*) but lower return on assets (*ROA*). In addition, politically connected firms are larger, in terms of total assets (*ASSETS*). As expected, connected firms have higher institutional ownership (*INSTOWN*) and more Bumiputra directors on the board (*BUMI*).

[Table 4 about here]

We extend the analysis by examining the differences in the mean and median between firms with a high and low proportion of Bumiputra directors. We divided the sample into quartiles, and ran univariate analyses between the fourth (highest) and first (lowest) quartiles. The results presented in Table 5 suggest that firms with a high level of Bumiputra directors incurred a significantly higher level of audit fees and non-audit fees. In addition, we find that firms with a higher level of Bumiputra directors are significantly larger (*ASSETS*), have a higher level of institutional ownership (*INSTOWN*), and more subsidiaries (*SUBS*). Our findings, based on Tables 4 and 5, do give initial support that being connected could result in higher risk assessment by the auditor.

[Table 5 about here]

4.2 Multivariate Analysis

4.2.1 Political connections, Non-audit fees and audit fees

Table 6 presents the regression results. Column 1 of Table 6 tabulates the regression results without the experimental variables. We find a positive and significant constant term (*INTERCEPT*) suggesting that, on average, audit engagement does incur a start-up cost. We find significant and expected relationships for *ASSETS, INSTOWN, SQSUBS, SQFOREIGN, LIQUID* and *ROA*. Our choice of variables explains about 57.3 percent of the variation in audit fees for the sample firms. This figure is lower than Gul (2006) but similar to Abdul Wahab *et al*. (2009).

Column 2 of Table 6 presents the regression results without the interaction variable and includes proxies for political connections, i.e. *POLCON* and *BUMI*. The coefficients for both political connections proxies are positive, but only *POLCON (*0.244; t=1.796; *p<0.10)* is significant at the 10 percent level for all models. This result suggests that auditors perceive connected firms to be riskier, and charge higher audit fees. The results for control variables are consistent with the results in column 1 of Table 6. Column 3 of Table 6 includes *LNAF* as another determinant for *LAF*; as expected, we find a positive and significant relationship between *LNAF* and *LAF (*0.197; t=6.191*; p<0.01)*. This finding is consistent with the extant literature, which suggests that a positive relationship could arise between the auditor issuing non-audit services and audit fees (Simunic, 1984; Hay *et al*., 2006), and, thus, supports our first hypothesis, H_1.

The coefficients for our interaction variables (*POLCON*LNAF* and *BUMI*LNAF*), are presented in column 4 of Table 6. Although the directions of the coefficients are negative and thus consistent with our expectations, only the interaction between *BUMI* and *LNAF* (-0.281; t=-2.472*; p<0.05)* is significant. Our findings suggest that the positive relationship hypothesised earlier between *LNAF* and *LAF* is weaker in politically-connected firms, as proxied by the proportion of Bumiputra directors and thus supports H_5. This finding suggests that knowledge spillover is lower in politically-connected firms. Alternatively, we could view this finding as those non-audit services are used by auditors to help them assess the level of risk for politically-connected firms. Nevertheless, these arguments suggest that political connections could pose a threat to auditor independence, at least in appearance. The results for all control variables are consistent, which suggests the robustness of the models used.

[Table 6 about here]

4.2.1.1 Endogeneity

Numerous studies (e.g. Whisenant *et al.*, 2003; Hay *et al*., 2006) examine the joint determination of audit fees and non-audit fees by running simultaneous equations using two-stage-least-squares estimation. We posit the following non-audit fees (*LNAF*) model, to be used to provide an estimation of *LNAF,* which is substituted in the AF model above:

$$LNAF = b_0INTERCEPT_{it} + b_1POLCON_{it} + b_2ASSETS_{it} + b_3INSTOWN_{it} + b_4MANOWN_{it} + b_5SQSUBS_{it} + b_6SQFOREIGN_{it} + b_7CURRENT_{it} + b_8LIQUID_{it} + b_9BIGN_{it} + b_{10}ROA_{it} + b_{11}LOSS_{it} + b_{12}DEBT_{it} + b_{13}YE_{it} + b_{14}BUMI_{it} + b_{15}GR\_SALES_{it} + b_{16}MTBV_{it} + INDUSTRY_{it} + PERIOD_{it} + e_{it}$$

We have provided two instruments, namely, previous growth in sales (*GR_SALES*) and market to book value (*MTBV*).[20] The 2SLS result is shown in column 2 of Table 7. As in Whisenant *et al*. (2003) and Hay *et al*. (2006), there is no relationship between *LAF* and *LNAF* when the two-stage least squares is used, suggesting that they are jointly determined.

[Table 7 about here]

5.0 Conclusion

This paper adds to the stream of burgeoning literature on auditor independence and political connections by considering whether political connections moderate the relationship between audit fees and non-audit fees.

Our evidence, based on client-year sample of 379 during 2001-2003 periods, suggests that politically-connected firms pay a significantly higher level of non-audit fees than non-connected firms. Further analysis finds evidence to suggest that political connections (proxied by the proportion of Bumiputra directors) moderate the relationship between non-audit fees and audit fees. In fact, we find a weaker relationship between non-audit fees and audit fees for politically-connected firms.

The results also suggest that the knowledge spillover is lower in politically-connected firms where the non-audit services are used by auditors to make audit judgement. Our analysis suggests political connections impair the auditor independence both in appearance and in mind. We view the findings of this study as important, as they support the three suppositions we mentioned earlier in the paper, namely, political interest and the subsequent effect of audit failure, prospect of corporate bailout and

unconscious bias due to media coverage do influence auditors' judgement and independence.

However, this study is subject to a number of limitations. First, due to data limitation we were unable to identify the types of non-audit services provided by the auditor. The information on different types of non-audit services could offer us a better understanding of their roles and the effect on auditor independence. In addition, we were unable to identify whether or not the non-audit services provided are recurring, since recurring non-audit services could further undermine auditor independence (Beck *et al*., 1988). Furthermore, we do not consider whether there is any differences between incumbent and non-incumbent provider of audit services as highlighted by Palmrose (1986). Another limitation is that we were unable to identify whether the non-Bumiputra directors are politically linked, nonetheless, we made an assumption that the Bumiputra directors are politically linked due to the institutional set-up for politically linked firms. These limitations present ample opportunity for further research.

Furthermore, our analysis of politically connected firms is highly dependent on the list of political connections provided by Johnson and Mitton (2003). A further examination or in-depth interviews concerning the uniqueness of the political scene in Malaysia is much warranted.

[1] These are government link firms which are identified as politically connected firms. These firms are funded and supported financially to ensure adequate economies of scale. The term Bhd stands for Limited.

[2] Auditor independence includes the conditional probability that auditors will both find and report misrepresentation in financial statements (DeAngelo, 1981) and the ability to resist client pressure (Knapp, 1985).

[3] The NEP was succeeded by the National Development Policy in 1991, which was succeeded by the New Economic Model in 2010. Nevertheless, the main thrust of these models and policies is still based on wealth creation for the multi-races.

[4] The NEP had the stated goal of poverty eradication and economic restructuring so as to eliminate the identification of ethnicity with economic function. The initial target was to move the ratio of economic ownership in Malaysia from a 2.4:33:63 ratio of Bumiputras, Other Malaysian, Foreign ownership to a 30:40:30 ratio. This was to be done by redistributing the wealth to increase the ownership of enterprise by Bumiputras from the then 2.4% to 30% of the share of national wealth.

[5] Independence is separated into two related concepts. First, independence requires independence in mind, defined as a state of mind that is (1) unaffected by influences that might compromise professional judgment, and that (2) allows an individual to act with integrity and to exercise objectivity and professional skepticism. Second, 'independence in appearance", which can be described as the avoidance of significant facts and/or circumstances that would reasonably cause a rational and informed third party to conclude that a firm's (or member of the assurance team's), integrity, objectivity or professional skepticism had been compromised (International Federation of Accountants, 2004, p.17).

[6] In Malaysia, the Malaysian Institute of Accountants (MIA) By-Laws (revised 2002) suggests that non-audit service fees must not exceed 15 percent of a firm's total revenue. However, the MIA By-Laws stop short of specifying the maximum limit of non-audit service fees receivable from a client. In addition, Bursa Malaysia requires all listed firms to disclose non-audit fees in their annual reports effective June 2001 (Che Ahmad *et al*., 2006).

[7] UMNO is the United Malays National Organisation, formed in 1946. MCA is the Malaysian Chinese Association, formed in 1948, while the MIC is the Malaysian Indian Congress, founded in 1946.

[8] The term self-serving refers to cognitive characteristic that individuals cannot separate their own self-interest from that of others in close proximity with whom they interact closely.

[9] The authors would like to note that firms connected to the current Prime Minister are not part of the sample. We do not have the current data and the studies conducted by Johnson and Mitton (2003) did not take into consideration firms connected to the current Prime Minister.

[10] Guanxi could be formally translated as relationships or connections (Liu *et al*., 2011)

[11] Che Ahmad *et al*. (2006) data inclusive of firms listed on the Main, Second and Mesdaq Board of Bursa Malaysia.

[12] We did not attempt to identify the exact threats, as the data cannot be easily gathered.

[13] Tun Mahathir and Tun Abdullah Ahmad Badawi are the 4th and 5th Prime Minister, respectively.

[14] We use audit fees since we are interested in capturing the extent of auditor investigation. It is reasonable to assume that more investigation will require more audit hours and/or the use of more specialised audit staff, resulting in higher audit fees (O'Sullivan, 2000). Further, the use of audit fees to proxy for audit quality would be appropriate since the audit quality of a firm is unobservable (O'Sullivan, 2000). The initiative for more (less) audit effort and higher (lower) fees could come from either the auditor or the auditee firm.

[15] Please see appendix A for the list of politically-connected firms.

[16] We created a continuous variable of proportion of Bumiputra directors. Unfortunately, we do not have the list of Bumiputra firms, which could be used as another proxy for political connections. We are inclined to believe that the role of Bumiputras directors might go beyond the role with significant shareholdings.

[17] Khazanah Nasional Berhad is the investment holding arm of the government of Malaysia to manage its commercial assets. It is the trustee to the nation's financial assets. Its objectives are "to promote economic growth and make strategic investments on behalf of the government which would contribute towards nation building". It was incorporated in September, 1993 and began operations in 1994. It is structured into a holding company that is a wholly owned entity of the Ministry of Finance (MOF), which is part of the Malaysian Government.

[18] The relationship between institutional investors and managerial ownership is rather mechanical and an endogenous one. We based our prediction on existing theories, rather than on their complex relationship with each other.

[19] The regression results are not presented with industries and period fixed effects. The results can be obtained from the corresponding author.
[20] We ran the instrumental variables test as suggested by Larker and Rusticus (2008). We find that the instruments are weak, which might influence the findings.

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Appendix A: List of Politically-Connected Firms

1	BCB	30	MALAYSIA INTL. SHIPPING
2	BERJAYA GROUP	31	MALAYSIAN AIRLINE SY.
3	BERJAYA LAND 'A'	32	MALAYSIAN PACIFIC INDS.
4	BERJAYA SPORTS TOTO	33	MALAYSIAN RES.
5	BIMB HOLDINGS	34	METACORP
6	BOUSTEAD HOLDINGS	35	MULPHA INTERNATIONAL
7	CAHYA MATA SARAWAK	36	MULTI VEST RESOURCES
8	CAMERLIN GROUP	37	MYCOM
9	COMMERCE ASSET-HLDG.	38	PARK MAY
10	DAMANSARA REALTY	39	PHARMANIAGA
11	DRB-HICOM	40	PHILLEO ALLIED BHD
12	EDARAN OTOMOBIL NASIONAL	41	PROTON HOLDINGS
13	FABER GROUP	42	RASHID HUSSAIN
14	FCW HOLDINGS	43	RHB CAP.
15	GEORGE TOWN HOLDINGS	44	SAPURA TECHNOLOGY
16	GOLDEN HOPE PLTN.	45	SIME DARBY
17	GRANITE INDUSTRIES BHD	46	STAR PUBLICATION (MAL.)
18	HO HUP CONSTRUCTION	47	TAIPING CONSOLIDATED BHD
19	HONG LEONG BANK	48	TANJONG (MAL)
20	HONG LEONG CREDIT	49	TELEKOM MALAYSIA
21	HONG LEONG INDUSTRIES	50	TENAGA NASIONAL
22	HUME INDUSTRIES MAL.	51	THE NEW STRAITS TIMES PRESS (M) BHD
23	JAYA TIASA HOLDINGS	52	TIME ENGINEERING
24	KRETAM HOLDINGS	53	UDA HOLDINGS
25	KUMPULAN GUTHRIE	54	UNIPHONE TELECOMMUNICATIONS BHD
26	LAND & GENERAL	55	UTUSAN MELAYU (MALAYSIA)
27	LANDMARKS	56	YTL CEMENT
28	MALAKOFF	57	YTL CORPORATION BHD
29	MALAYAN BANKING	58	YTL POWER

Table 1: Definition and Expected Direction of Variables

#	Variables	Sign	Definition	Source
Panel A: Dependent Variables				
1	*LAF*		Natural logarithm of audit fees.	Compustat Global and Annual reports.
Panel B: Experimental Variables				
2	*LNAF*	+	Natural Logarithm of non-audit fees	Annual reports.
3	*POLCON*	+	An indicator variable, 1 for politically-connected firms, 0 otherwise.	Johnson and Mitton (2003), Mohamad *et al.* (2006) and Khazanah Berhad website (www.khazanah.gov.my).
4	*BUMI*	+	Proportion of *Bumiputra* directors on board.	Annual reports.
Panel C: Continuous Variables				
5	*ASSETS*	+	Natural logarithm of total assets.	Compustat Global, DataStream and Stock Performance Guide.
6	*INSTOWN*	+	Top five institutional shareholdings in each firm.	Annual reports.
7	*MANOWN*	-	Managerial ownership.	Annual reports.
8	*LNSUBS*	+	Natural logarithm of number of subsidiaries.	Mergent Online and Annual Reports.
9	*LNFOREIGN*	+	Natural logarithm of number of foreign subsidiaries.	Mergent Online and Annual Reports.
10	*CURRENT*	+	Current assets to total assets.	Compustat Global, DataStream and Stock Performance Guide.
11	*LIQUID*	+	Current assets to current liabilities.	Compustat Global, DataStream and Stock Performance Guide.
12	*ROA*	-	Net profit before tax over total assets.	Compustat Global
13	*DEBT*	+	Total debt to total equity.	Compustat Global, DataStream and Stock Performance Guide.
Panel D: Dichotomous Variable				
14	*OPINION*		An indicator variable, 1 for qualified or modified opinions, 0 otherwise.	Compustat Global and Annual reports.
15	*BIGN*	+	An indicator variable, 1 for Big 'n' audit firms, 0 otherwise.	Compustat Global and Annual reports.
16	*LOSS*	+	An indicator variable, 1 for loss in the last year.	Compustat Global
17	*YE*	-	An indicator variable, 1 for fiscal year ending 31st December, 0 otherwise.	Annual reports.

Table 2: Descriptive Statistics

	Mean	Median	Maximum	Minimum	Std. Dev.	Observations
Panel A: Continuous Variables						
AF('000)	424.3	167.0	9400	14.00	849.3	379
LAF	12.162	12.026	16.056	9.547	1.171	379
BUMI	0.455	0.385	1.000	0.000	0.280	379
NAF('000)	210.8	56.20	3100	1.000	467.6	379
LNAF	10.918	10.937	14.947	6.908	1.653	379
ASSETS('000)	2527000	696500	64270000	20320	6121000	379
LNASSETS	20.568	20.362	24.886	16.827	1.402	379
INSTOWN	13.686	7.293	90.553	0.000	18.466	379
MANOWN	6.351	0.467	64.117	0.000	12.248	379
SUBS	35.491	17.000	408.000	0.000	51.931	379
SQSUBS	4.841	4.123	20.199	0.003	3.476	379
FOREIGN	8.285	2.000	224.000	0.000	21.449	379
SQFOREIGN	1.837	1.414	14.967	0.003	2.219	379
CURRENT	0.377	0.341	4.664	0.000	0.369	379
LIQUID	3.482	1.624	105.012	0.022	7.952	379
ROA	5.379	5.853	140.162	-88.504	13.115	379
DEBT	0.692	0.224	19.970	0.000	1.723	379
Panel B: Dichotomous Variables						
OPINION	0.063	0.000	1.000	0.000	0.244	379
BIG_N	0.710	1.000	1.000	0.000	0.454	379
LOSS	0.174	0.000	1.000	0.000	0.380	379
YE	0.478	0.000	1.000	0.000	0.500	379

AF and *LAF* are audit fees and natural log transformation of AF, respectively. *BUMI* is the proportion of *Bumiputra* directors on the board. *NAF* and *LNAF* are non-audit fees and natural log transformation of NAF, respectively. *POLCON* takes the value of 1 if the firm is politically-connected. *ASSETS* and *LNASSETS* are total assets and natural log transformation of total assets, respectively. *INSTOWN* and *MANOWN* are institutional investors and managerial ownership, respectively. *SUBS* and *SQSUBS* are total subsidiaries and square root of *SUBS*, respectively. *FOREIGN* and *SQFOREIGN* are total foreign-domiciled subsidiaries and square root of *FOREIGN*, respectively. *CURRENT* is current assets to total assets. *LIQUID* is current assets to current liabilities. *ROA* is earnings divided by total assets. *DEBT* is total debt over total assets. *BIGN* takes the value of 1 for Big'n' auditors and zero otherwise. *LOSS* takes the value of 1 if the firm recorded a loss in the previous fiscal year. *YE* takes the value of 1 if the year end is December.

Table 3: Correlation Matrix for Continuous Variables

	LAF	*LNAF*	*ASSETS*	*INST*	*MANOWN*	*LNSUBS*[@]	*LNFOR*[@]	*CURR*	*LIQUID*	*ROA*	*DEBT*	*BUMI*
LAF		*0.547*[#]	*0.551*[#]	*0.358*[#]	*-0.195*[#]	*0.604*[#]	*0.557*[#]	*-0.027*	*-0.175*[#]	*0.057*	*0.067*	*0.177*[#]
LNAF	0.560[#]		*0.395*[#]	*0.225*[#]	*-0.225*[#]	*0.313*[#]	*0.287*[#]	*-0.130*[†]	*-0.257*[#]	*0.016*	*0.081**	*0.189*[#]
ASSETS	0.570[#]	0.418[#]		*0.408*[#]	*-0.284*[#]	*0.468*[#]	*0.418*[#]	*-0.300*[#]	*-0.115*[†]	*0.170*[#]	*0.078*	*0.045*
INSTOWN	0.445[#]	0.354[#]	0.408[#]		*-0.227*[#]	*0.183*[#]	*0.273*[#]	*-0.022*	*0.072*	*0.215*[#]	*-0.002*	*0.231*[#]
MANOWN	-0.223[#]	-0.222[#]	-0.193[#]	-0.180[#]		*-0.065*	*-0.002*	*0.007*	*0.079*	*0.004*	*-0.100**	*-0.309*[#]
LNSUBS[@]	0.299[#]	0.117	0.236[#]	0.087	0.033		*0.792*[#]	*-0.051*	*-0.231*[#]	*-0.118*	*0.041*	*0.136*
LNFOR[@]	0.423[#]	0.222[#]	0.322[#]	0.184[#]	0.034	0.587[#]		*0.013*	*-0.146*[#]	*-0.051*	*-0.005*	*-0.013*
CURRENT	-0.002	-0.102*	-0.214[#]	0.001	-0.030	-0.042	0.008		*0.404*[#]	*0.044*	*-0.153*[#]	*-0.022*
LIQUID	-0.235[#]	-0.160[#]	-0.218[#]	-0.095*	-0.022	-0.163[#]	-0.217[#]	0.117[†]		*0.330*[#]	*-0.270*[#]	*-0.151*[#]
ROA	0.046	0.011	0.131†	0.070	-0.015	-0.130†	-0.083*	-0.060	0.253#		*-0.071*	*-0.077*
DEBT	-0.035	-0.005	0.017	-0.046	-0.032	0.000	-0.061	0.011	-0.027	*-0.030*		*0.046*
BUMI	0.179#	0.196#	0.005	0.294#	-0.201#	0.088*	-0.038	0.091*	-0.137#	*-0.071*	*0.045*	

***** 10 percent significance level.
[#] 5 percent significance level.
[†] 1 percent significance level.

[@]Observations having a zero for *LNSUBS* or for *LNFOREIGN* are re-coded to a small positive (0.0001) to enable a logarithmic transformation.

Spearman-rank correlations are italicised. *LAF* and *LNAF* are natural log transformation of audit fees and non-audit fees, respectively. *POLCON* takes the value of 1 if the firm is politically-connected. *ASSETS* is natural log transformation of total assets. *INSTOWN* and *MANOWN* are institutional investors and managerial ownership, respectively. *LNSUBS* and *LNFOREIGN* are natural log transformation for total subsidiaries and foreign-domicile subsidiaries, respectively. *CURRENT* is current assets to total assets. *LIQUID* is current assets to current liabilities. *BIGN* takes the value of 1 for Big'n' auditors and zero otherwise. *SWITCH* is an indicator variable, which takes the value of 1 if the firm experiences changes in auditor. *ROA* is earnings divided by total assets. *LOSS* takes the value of 1 if the firm recorded a loss in the previous fiscal year. *DEBT* is total debt over total equity. *YE* takes the value of 1 if the year end is December. *AUDCOM BUMI* is the proportion of *Bumiputra* directors on board.

Table 4: Univariate Analysis in Differences in Audit Fees, Non-audit Fees and Control Variables between politically and non-politically connected firms

	Politic=1	n=105	Politic=0	n=292	t-test	Mann-Whitney
	Mean	Median	Mean	Median	(p-value)	(p-value)
Panel A: Continuous Variables						
AF('000)	996.4	473.0	253.9	135.0	**0.000**	**0.000**
LAF	13.023	13.067	11.905	11.813	**0.000**	**0.000**
BUMI	0.556	0.583	0.425	0.375	**0.000**	**0.000**
NAF('000)	582.6	119.0	99.99	41.50	**0.000**	**0.000**
LNAF	12.073	11.687	10.574	10.633	**0.000**	**0.000**
ASSETS('000)	7113000	3089000	1161000	570100	**0.000**	**0.000**
ASSETS	21.678	21.851	20.237	20.161	**0.000**	**0.000**
INSTOWN	24.155	12.546	10.567	5.820	**0.000**	**0.000**
MANOWN	2.800	0.060	7.409	0.700	**0.001**	**0.000**
SUBS	60.264	27.000	28.110	15.000	**0.000**	**0.000**
SQSUBS	6.393	5.196	4.379	3.873	**0.000**	**0.000**
FOREIGN	18.586	5.000	5.216	1.000	**0.000**	**0.000**
SQFOREIGN	3.037	2.236	1.479	1.000	**0.000**	**0.000**
CURRENT	0.440	0.331	0.359	0.341	**0.010**	0.666
LIQUID	1.817	1.337	3.978	1.775	**0.020**	**0.012**
ROA	4.328	4.977	5.692	6.350	0.100	**0.073**
DEBT	0.397	0.261	0.780	0.218	**0.097**	0.621
Panel B: Dichotomous Variables						χ^2
OPINION	0.057	0.000	0.065	0.000		0.698
BIG_N	0.816	1.000	0.678	1.000		**0.012**
LOSS	0.241	0.000	0.154	0.000		**0.014**
YE	0.425	0.000	0.493	0.000		0.302

AF and *LAF* are audit fees and natural log transformation of *AF*, respectively. *BUMI* is the proportion of *Bumiputra* directors on board. *NAF* and *LNAF* are non-audit fees and natural log transformation of *NAF*, respectively. *POLCON* takes the value of 1 if the firm is politically-connected. *ASSETS* and *LNASSETS* are total assets and natural log transformation of total assets, respectively. *INSTOWN* and *MANOWN* are institutional investors and managerial ownership, respectively. *SUBS* and *SQSUBS* are total subsidiaries and square root of *SUBS*, respectively. *FOREIGN* and *SQFOREIGN* are total foreign-domiciled subsidiaries and square root of *FOREIGN*, respectively. *CURRENT* is current assets to total assets. *LIQUID* is current assets to current liabilities. *ROA* is earnings divided by total assets. *DEBT* is total debt over total assets. *BIGN* takes the value of 1 for Big'n' auditors and zero otherwise. *LOSS* takes the value of 1 if the firm recorded a loss in the previous fiscal year. *YE* takes the value of 1 if the year end is December. Significant p-values are bold. Chi-square(χ^2) results are reported for dichotomous variables.

Table 5: Univariate Analysis in Differences in Audit Fees, non-audit fees and control variables between Firms with low and high proportion of *Bumiputra* directors

	High	n=93	Low	n=94	t-test	Mann-Whitney
	Mean	Median	Mean	Median	(p-value)	(p-value)
Panel A: Continuous Variables						
AF('000)	458.7	217.0	275.3	150.5	**0.006**	**0.003**
LAF	12.425	12.288	11.907	11.922	**0.001**	**0.003**
BUMI	0.832	0.833	0.139	0.143	**0.000**	**0.000**
NAF('000)	368.8	85.00	82.00	52.80	**0.000**	**0.003**
LNAF	11.488	11.350	10.633	10.874	**0.000**	**0.003**
ASSETS('000)	3773000	799300	1609000	550800	**0.037**	0.106
LNASSETS	20.687	20.499	20.293	20.127	**0.073**	0.106
INSTOWN	23.318	13.120	6.514	4.202	**0.000**	**0.000**
MANOWN	2.056	0.033	7.896	1.947	**0.001**	**0.000**
SUBS	38.903	20.000	22.872	14.500	**0.016**	**0.021**
SQSUBS	5.161	4.472	3.845	3.807	**0.011**	**0.021**
FOREIGN	6.828	2.000	5.245	2.000	0.608	0.957
SQFOREIGN	1.679	1.414	1.567	1.414	0.750	0.957
CURRENT	0.426	0.325	0.389	0.346	0.571	0.310
LIQUID	2.638	1.331	5.580	1.756	**0.016**	**0.022**
ROA	4.908	5.182	6.797	7.526	0.356	0.120
DEBT	0.702	0.216	0.792	0.226	0.559	0.743
Panel B: Dichotomous Variables						χ^2
OPINION	0.054	0.000	0.053	0.000		0.922
BIG_N	0.742	1.000	0.787	1.000		0.563
LOSS	0.215	0.000	0.149	0.000		0.183
YE	0.548	1.000	0.457	0.000		0.310

AF and *LAF* are audit fees and natural log transformation of AF, respectively. *BUMI* is the proportion of *Bumiputra* directors on board. *NAF* and *LNAF* are non-audit fees and natural log transformation of NAF, respectively. *POLCON* takes the value of 1 if the firm is politically-connected. *ASSETS* and *LNASSETS* are total assets and natural log transformation of total assets, respectively. *INSTOWN* and *MANOWN* are institutional investors and managerial ownership, respectively. *SUBS* and *SQSUBS* are total subsidiaries and square root of *SUBS*, respectively. *FOREIGN* and *SQFOREIGN* are total foreign-domiciled subsidiaries and square root of *FOREIGN*, respectively. *CURRENT* is current assets to total assets. *LIQUID* is current assets to current liabilities. *ROA* is earnings divided by total assets. *DEBT* is total debt over total assets. *BIGN* takes the value of 1 for Big'n' auditors and zero otherwise. *LOSS* takes the value of 1 if the firm recorded a loss in the previous fiscal year. *YE* takes the value of 1 if the year end is December. Significant p-values are bold. Chi-square (χ^2) results are reported for dichotomous variables.

Table 6: Models of Audit Fees, Non-audit Fees and Control Variables

	Expected Direction	*LAF* 1	*LAF* 2	*LAF* 3	*LAF* 4
INTERCEPT	+	5.687	6.264	5.565	4.012
		5.867*	***6.070****	***5.660****	***3.444****
POLCON	+		0.244	0.134	0.259
			1.796*	*1.034*	*0.335*
BUMI	+		0.032	-0.069	2.948
			0.165	*-0.371*	***2.409***
LNAF	+			0.197	0.326
				6.191*	***5.439****
*POLCON*LNAF*	+/-				-0.006
					-0.085
*BUMI*LNAF*	+/-				-0.281
					-2.472*
LNASSETS	+	0.286	0.256	0.186	0.194
		6.137*	***5.181****	***3.838****	***4.026****
INSTOWN	+	0.013	0.012	0.009	0.011
		4.516*	***3.920****	***3.160****	***3.659****
MANOWN	-	-0.006	-0.006	-0.004	-0.004
		-1.453	*-1.396*	*-1.090*	*-1.026*
SQSUBS	+	0.050	0.055	0.050	0.056
		1.765*	***1.902****	***1.815****	***2.050***
SQFOREIGN	+	0.100	0.093	0.090	0.076
		2.348	***2.106***	***2.144***	***1.817****
OPINION	+	0.068	0.094	0.037	0.063
		0.360	*0.496*	*0.206*	*0.354*
CURRENT	+	0.179	0.129	0.131	0.136
		1.566	*1.119*	*1.217*	*1.276*
LIQUID	-	-0.018	-0.018	-0.016	-0.014
		-2.893*	***-2.902****	***-2.853****	***-2.506****
BIG_N	+	0.060	0.043	-0.049	-0.049
		0.597	0.425	*-0.518*	*-0.515*
ROA	+	0.011	0.012	0.010	0.010
		3.111*	***3.240****	***2.948****	***2.962****
LOSS	-	0.159	0.096	0.044	0.022
		1.266	*0.750*	*0.364*	*0.185*
DEBT	+	-0.004	-0.005	0.000	-0.007
		-0.163	*-0.205*	*0.017*	*-0.296*
YE	+	0.145	0.156	0.113	0.124
		1.431	*1.552*	*1.186*	*1.312*
Period fixed (dummy variables)	+/-	Yes	Yes	Yes	Yes
Industry fixed (dummy variables)	+/-	Yes	Yes	Yes	Yes
Adjusted R-squared		0.573	0.577	0.577	0.632
F-statistic		***29.200****	***26.371****	***26.731****	***29.255****

LAF and *LNAF* are natural log transformation of audit fees and non-audit fees, respectively. *POLCON* takes the value of 1 if the firm is politically-connected. *ASSETS* is natural log transformation of total assets. *INSTOWN* and *MANOWN* are institutional investors and managerial ownership, respectively. *LNSUBS* and *LNFOREIGN* are natural log transformation for total subsidiaries and foreign-domicile subsidiaries, respectively. *CURRENT* is current assets to total assets. *LIQUID* is current assets to current liabilities. *BIGN* takes the value of 1 for Big'n' auditors and zero otherwise. *ROA* is earnings divided by total assets. *LOSS* takes the value of 1 if the firm recorded a loss in the previous fiscal year. *DEBT* is total debt over total equity. *YE* takes the value of 1 if the year end is December. *BUMI* is the proportion of *Bumiputra* directors on board. t-statistics are italicised. *, ** and *** represent 10, 5 and 1 percent significant values, respectively.

Table 7: Two-Stage-Least Squares of Audit Fees, Non-audit fees and Control Variables

	Expected Direction	*OLS* *LAF* 1	*2SLS* *LAF* 2
INTERCEPT	+	5.565	6.159
		5.660*	***2.869****
POLCON	+	0.134	0.153
		1.034	*0.576*
BUMI	+	-0.069	-0.268
		-0.371	*-0.776*
LNAF	+	0.197	0.313
		6.191*	*0.643*
ASSETS	+	0.186	0.100
		3.838*	*0.534*
INSTOWN	+	0.009	0.007
		3.160*	*0.832*
MANOWN	-	-0.004	-0.006
		-1.090	*-0.979*
SQSUBS	+	0.050	0.053
		***1.815**	***1.672**
SQFOREIGN	+	0.090	0.092
		2.144*	***1.813**
OPINION	+	0.037	-0.027
		0.206	*-0.121*
CURRENT	+	0.131	0.111
		1.217	*0.755*
LIQUID	-	-0.016	-0.013
		-2.853*	*-1.400*
BIG_N	+	-0.049	-0.130
		-0.518	*-0.511*
ROA	+	0.010	0.009
		2.948*	***1.693**
LOSS	-	0.044	-0.097
		0.364	*-0.481*
DEBT	+	0.000	0.020
		0.017	*0.438*
YE	+	0.113	0.054
		1.186	*0.290*
Period Fixed (dummy variables)	+/-	Yes	Yes
Industry Fixed (dummy variables)	+/-	Yes	Yes
Adjusted R-squared		0.626	0.536
F-statistic		***31.150****	***14.794****

LAF and *LNAF* are natural log transformation of audit fees and non-audit fees, respectively. *POLCON* takes the value of 1 if the firm is politically-connected. *ASSETS* is natural log transformation of total assets. *INSTOWN* and *MANOWN* are institutional investors and managerial ownership, respectively. *LNSUBS* and *LNFOREIGN* are natural log transformation for total subsidiaries and foreign-domicile subsidiaries, respectively. *CURRENT* is current assets to total assets. *LIQUID* is current assets to current liabilities. *BIGN* takes the value of 1 for Big'n' auditors and zero otherwise. *ROA* is earnings divided by total assets. *LOSS* takes the value of 1 if the firm recorded a loss in the previous fiscal year. *DEBT* is total debt over total equity. *YE* takes the value of 1 if the year end is December. *BUMI* is the proportion of *Bumiputra* directors on board. t-statistics are italicised. *, ** and *** represent 10, 5 and 1 percent significant values, respectively.