[illegible]SION OF NON-AUDIT SERVICES, AUDIT FEES AND AUDITOR INDEPENDENCE

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[illegible] of this study are to examine the effect of non-audit services on audit fees, to investigate the [illegible]ween non-audit fees and the issuance of qualified audit opinion, and to analyse the proportion of [illegible] to total fees paid by a client to its auditor. The regression analysis reveals a significant positive [illegible]tween audit fees and non-audit fees, which is contrary to the theory available in the literature. [illegible]re done and alternative explanations are provided. The results obtained from the t-test suggest a [illegible]lationship between non-audit fees and qualified audit opinions. The outcomes indicate that on [illegible] opinions are dependent on the amount of non-audit fees. Finally, the descriptive analysis presents [illegible]development about the ratio of non-audit fees to total fees. The study suggests ways to improve the [illegible] issues in Malaysia.

[illegible] *Non-Audit Services, Audit Fees, Auditor Independence, Audit Opinion*

[illegible]UCTION

[illegible]2002 had seen the biggest corporate collapses in the United States history that subsequently raised lots [illegible]ons regarding auditors' independence. Arthur Andersen, being the auditor of the three biggest [illegible]ptcies, Enron, WorldCom and Global Crossing, was heavily criticised for the collapses. Andersen was [illegible] stressing more on NAS than the audit itself. Auditing profession as a whole has been badly blamed [illegible]nges were being proposed to ensure that audit firms reduce their over-reliance on NAS (The Star, 2002). [illegible] to ensure the independence of auditors and to protect the interest of the investors, the accounting [illegible]ssion in most countries has came up with a code of ethics that spells out guidelines for auditors' [illegible]petency and independence. In Malaysia, the Malaysian Institute of Accountant (MIA) By Law (On [illegible]fessional Conduct and Ethics) (revised 2002) suggests that audit firms should not accept any appointment if [illegible] were also providing NAS to a client; whereby the provision of NAS would create a significant threat to [illegible] professional independence, integrity and objectivity. On top of that, Bursa Malaysia (previously known as [illegible]ala Lumpur Stock Exchange or KLSE) requires all listed companies to disclose non-audit fees in their annual [illegible]ports beginning 1 June 2001. The aim is to protect shareholders' interests and increase corporate transparency.

This study examines the effect of non-audit fees on audit fees in public listed companies (hereinafter PLCs) in Malaysia; analyses the effects of non-audit fees on the issuance of qualified audit opinion; and investigates the proportion of NAS fees to total audit fees. In light of the introduction of the Sarbanes-Oxley Act 2002 (SOX) in the USA, this study also provides descriptive evidence on the ratio of NAS fees to total audit remuneration for the listed companies in Malaysia. The results could be used by the MIA, which is still studying the implication of the SOX before introducing a similar rule in Malaysia. The SOX 2002 states that NAS provided to a client should not be more than 5% of the total auditor remuneration; otherwise, the client must obtain pre-approval from its audit committee, as non-audit fees paid in excess of this percentage would deem auditors as not being independent. In Malaysia, under MIA rules that effective 15 January 2002, professional independence is considered impaired if total fees arising from provision of NAS to a client is 20 per cent or more of the audit firm's total annual fees received for two or more consecutive years. The regulators must give emphasis on the impact of NAS to the audit fees especially if there is a negative relationship between NAS and audit fees that is due to a "loss leader" theory. The positive relationship between NAS fee and the issuance of clean audit opinion should also be of concern to the regulators as it could affect independence.

HYPOTHESIS DEVELOPMENT

In general, audit firms provide various NAS such as tax consultancy, system consultancy, management advice, international business advice, human resource management, and financial and investment consultancies (Firth, 1997). A number of studies were done that address the issues relating to audit fees and its determinants in various settings (Firth, 1997). Simunic (1980) began the studies on audit fees by developing a model that includes factors representing client size, complexities and risk that explains for the variation in audit fees.

Subsequently, he found that auditee size, complexity and risk were positively related to audit fees, and no relationship exists between audit fees and the Big Eight auditors in both large and small auditee markets (Simunic 1980). Later, similar studies were carried out in countries such as the United Kingdom (e.g. Chan, et al., 1993) and Australia (Butterworth and Houghton, 1995; and Craswell et al., 1995). These studies used archival data and regression analyses were employed.

Non-Audit Fees and Audit Fees

Simunic (1984) argued that a negative relationship between audit fees and NAS fees would happen due to the trade off between audit fees and NAS fees as explained by the knowledge spillover theory in which auditors utilise the knowledge obtained from the non-audit works into their audit works. The benefits from the knowledge spillover effects may be passed on to the companies by reducing the audit fees. Another explanation is that the audit is used as a "loss leader" to obtain the more lucrative consultancy works. The effect reduces the audit fees and the "loss" is captured by increasing NAS fees (Hillison and Kennelley, 1988). This would also occur if the audit firms avoid a dismissal by reducing the audit fees and then try to recoup the loss by increasing the NAS fees.

Hence, a negative relationship between audit fees and non-audit fees would prevail. Based on this reasoning, it is hypothesized that (in null form),

$H_0 1$ = There is no significant relationship between audit fees and non-audit fees paid by the client companies.

Despite these theories, many empirical studies found that the non-audit fees were positively and significantly related to the audit fees (see for example, Simunic, 1984; and Firth, 1999). Firth (2002) explained that the contradictory findings might be due to specific events in the company that generated a demand for consultancy services as well as requiring additional audit efforts. In contrast, Butterworth and Houghton (1995), Mohd Atef and Ayoib (2000) and Ayoib (2001) found no statistically significant relationship between audit fees and non-audit fees exist. In Malaysia Rohami et al. (2003) is the only one that found negative relationship between audit fees and non-audit fees in highly regulated banking sector. The results, however, cannot be generalized to other sectors. Teoh and Lim (1996), found that the disclosure on non-audit fees would influence and impair audit independence. A survey done by Gul and Teoh (1986) in Malaysia, suggested that the provision of NAS reduces public's confidence in auditors independence.

NAS and Audit Opinion

Various studies have been done in foreign settings to see whether the provision of NAS affects auditors' reporting decision. However, the results of previous studies were conflicting. Wines (1994) found that the auditors of companies that received clean reports over the period derived a significantly higher proportion of their remuneration from NAS fees than the auditors of companies that received at least one audit qualification. These findings suggest that auditors were less likely to give qualified reports to clients' financial statements when high levels of NAS fees are involved. Craswell (1999) and DeFond et al. (2002) found that auditors' decision to qualify their opinion is not affected by the provision of NAS. Contrary to this, Firth (2002) found that companies that have relatively high consultancy fees were more likely to receive a clean audit opinion due to the non-audit work clearing up problem areas at the client company; or it might be due to high consultancy fees, thus impairing auditor independence. However, it is not possible to distinguish between these two reasons. Other studies such as Frankel et al. (2002) revealed that companies in the United States, which purchased NAS, were more likely to report earnings that just met or exceeded analysts' earnings forecast.

Simunic (1984) argued that a negative relationship between audit fees and non-audit fees would occur due to trade off between audit fees and non-audit fees as a consequence of the knowledge spillover effects. A study by Rohami et al. (2003) also found a negative relationship between audit fees and non-audit fees. This negative relationship might be due to either knowledge spillover effect or loss leader effect. The knowledge spillover effect results in costs saving. Subsequently, both fees would be lower. However, the growth of audit fees is likely to be lower than the non-audit fees due to the same audit output purchased by the companies over the years. This is not the case for NAS, which would vary across the client companies, as some of the NAS may not be recurring in nature.

Auditor can be interpreted to compromise its independence if the provision of NAS is significantly tied to the issuance of clean audit opinion. Wines (1994) and Firth (2002) found that auditors were less likely to qualify their audit opinion when high levels of NAS are carried out to the clients. Another concern regarding the provision of NAS is that the consulting nature of many NAS could create inherent conflicts that potentially threatening auditors' objectivity (DeFond et al., 2002). Hence, it is hypothesized (in null form),

H_02 = There is no significant relationship between non-audit fees and the issuance of clean audit reports to the client companies.

Note that while auditor independence may have been compromised if it is found that there is an association between consultancy fees and clean audit reports, there is also an alternative explanation for the association. The positive association could be due to improvement in client's internal control or operation as a result of consultancy works and that may increase the probability of unqualified opinions.

METHODOLOGY

The subjects for this study are composed of the entire population of PLCs of Main Board, Second Board and Mesdaq, which totaled to 868 companies. Data are from 2002 annual reports. After excluding annual reports that were not available or with missing data, the final sample was 819.

For the testing of the first hypothesis (H1), this study replicates the audit-pricing model from Simunic (1980) and uses the Ordinary Least Squares model to analyse the data.
The research model is as follows:

$$\begin{aligned} LOGFEE = \; & \beta_0 + \beta_1 LOGNAS + \beta_2 LOGASSETS + \beta_3 LOGSUBS + \beta_4 INVREC + \\ & \beta_5 LEVERAGE + \beta_6 OPINION + \beta_7 AUDITOR + \beta_8 FOREIGN + \\ & \beta_9 CHINESE + e \end{aligned}$$

The measurements of the variables are as follows:

Dependent Variable Measurement

LOGFEE	=	Natural log of total audit fees of group level
Experimental variable		
LOGNAS	=	Natural log of the NAS fees
Independent Control Variables Measurement		
LOGASSETS	=	Log_{10} of total assets
LOGSUBS	=	Log_{10} of the number of consolidated subsidiaries
INVREC	=	Total Inventories and Account receivables to total assets
LEVERAGE	=	Total long-term debt (excluding deferred tax) to total equity
OPINION	=	Indicator variable having a value of 1 if the firm receives a qualified audit opinion and 0 if otherwise
AUDITOR	=	Indicator variable having a value of 1 if the auditor is the Big Five firm, and 0 if otherwise
FOREIGN	=	Total foreign directors to total directors
CHINESE	=	Total ethnic Chinese directors to total directors
e	=	Error term
β_i	=	constant (i = 0), regression coefficients (i=1,2,3...9)

Explanation and Measurement of Variables

Audit Fees Audit fees are measured by the dollar value of audit fees paid by the company to the auditor; transformed to logarithmic data to correct for non-normality in the distribution of the data.

Non-Audit Services Fees Measured by dollar value of NAS fees paid to the auditor by the company and transformed due to its non-linear relationship with audit fees.

Auditee Size Measured by total assets; transformed to logarithmic data.

Auditee Complexity Two variables are used as the proxies for the Auditee's complexity; the numbers of subsidiaries measured by logarithmic transformation of total subsidiaries plus holding company;and the ratio of total inventories and account receivables to total assets. This is due to two distinct forms of complexity that are relevant to auditors in performing auditing works.

Leverage Francis and Stokes (1986); and Low et al. (1990) found a positive and significant relationship between audit fees and leverage. Leverage is the proxy of the company risk.

Opinion Many studies have found that audit opinion has a significant positive relationship with the audit fees (Palmrose, 1986; Francis and Simon, 1987). This variable is a proxy for audit risk.

Auditor Previous studies in the United States (e.g. Palmrose, 1986 and Francis and Simon, 1987) as well as in the Malaysian market (Rose, 1999; and Ayoib, 2001) showed positive relationship between Big Five firms and audit fees. This is due to the effect of Big Five's reputation.

Foreign Foreign companies that are multinational companies demand high levels of audit quality to satisfy international investors and place more value on the international reputations of the Big Six auditors than do domestic firms (Rose, 1999).

Chinese Ayoib (2001) suggested that audit pricing was effected by ethnic business practice of the client companies. Local Chinese controlled and/or owned companies paid the lowest audit fees as compared with Bumiputra and foreign owned companies. Ayoib (2001) stated the reasons because of ordering of audit quality demanded being closely related to the segmental capital formation due to differences in levels of agency conflicts and risks associated with these companies.

RESULTS AND DISCUSSION

Descriptive and Univariate Analyses

Most of the annual reports disclosed the purchased of NAS fees under the Statement of Corporate Governance Report. Other disclosures were found in the Notes to the Account and Additional Compliance Information. 140 companies (17%) did not report NAS fees in any location in the annual reports. Given the disclosure is mandatory under the new rule, they are assumed to be companies that did not purchase NAS in the year 2002.

Table 1 displays the descriptive statistics of proportion of NAS fees to total fees and the frequency of NAS fee ratio for the total sample of 819 companies and 512 companies that purchased NAS.

Table 1: Proportion of NAS fees to Total Fees and Frequency of NAS fee (for the Total Sample of 819 Companies and 512 Companies that Purchased NAS)

Panel A. Proportion of NAS Fee

NAS Fee	N=819	N=512
Minimum	0.00	0.01
Maximum	0.99	0.99
Mean	0.23250	0.37190
Standard Deviation	0.26466	0.24530

Panel B. Frequency of NAS Fees Ratio

Percentage of NAS Fees	N=819	Percent	N=512	Percent
0%	307	37.5	0	0.0
0.1-05%	53	6.5	53	10.4
06-19%	95	11.6	95	18.6
20-39%	138	16.8	138	27.0
40-59%	118	14.4	118	23.0
60-79%	78	9.5	78	15.2
80-99%	30	3.7	30	5.8
Total	819	100.0	512	100

As shown in Panel A, the minimum proportion of NAS fee is one percent whilst the maximum is 99% of total auditor remuneration. Panel B shows that almost 90% of the NAS-purchased companies have NAS fee ratio of more than five percent. If the US's SOX 2002 is used as the benchmark, 90% of the auditors of NAS-purchased companies in Malaysia in 2002 were not independent in providing the auditing service. The MIA rule is silent on the proportion of NAS fee over total auditor remuneration for a particular client that can be considered to impair auditor independence. To our surprise, 21% of the auditors had NAS fee ratio of 60% or more. This is obviously more than what the auditor of Enron earned from the NAS fee and should be a cause for concern.

We also found that the Big 5 auditors dominates the market in the year 2002 having market share of more than 70%; with KPMG holding 18% of total clients, Ernst and Young 17%, Arthur Andersen 16%, Price WaterhouseCoopers 15% and Deloitte Touche Tohmatsu at seven percent. In addition the Big 5 also dominated the market for all industrial sectors with more than 50% market share in each sector.

The average total assets of the total sample were valued at about RM 1.8 billion. On average, the PLCs have 18 subsidiaries. Total audit fees of the full sample averaged RM194,960 while the average total non-audit fees for the sample was RM127,460. For NAS-purchased companies, the average audit fees amounted to RM241,940, with the NAS fee averaging RM203,890. In other words, for every dollar of audit fees in the year 2002, the clients paid their auditors 84 cents for other consultations.

Univariate tests were also done and they are consistent with the multivariate analysis. However, the main conclusion of the study will be based on the multivariate results. (Report on univariate tests are available upon request).

Multivariate Regression Analysis

The regression analysis (i.e. the first model) tests Hypothesis H1. The results are presented in Table 2 below. The results contain both the OLS regressions for the full sample and for NAS-purchased companies. Both models are well specified as evidenced by high F statistics. The R2 of both equations are in excess of 70% and they are consistent with prior studies. Further, the results are similar for both samples. More importantly, the hypothesis variable LOGNAS is significant at one percent level for both regressions. However, the sign of the coefficient is in the opposite direction of the theory proposed earlier. There is a significant positive relationship between audit fees and NAS fees. The explanation to this finding of the hypothesis variable is provided in the Discussion section below.

Table 2: Regression Results Using the Full Samples (N=819) and NAS Fee Incurred Companies (N=512)

Variables@	Expected Sign	N=819		N=512	
		Coefficient	*t*-statistic	Coefficient	*t*-statistic
LOGNAS	-	.051	5.284**	.098	5.988**
LOGASSETS	+	.251	12.407**	.274	14.597**
LOGSUBS	+	.560	18.606**	.533	19.773**
INVREC	+	.002	10.246**	.214	5.104**
LEVERAGE	+	-.002	-0.453	-.003	-0.511
FOREIGN	+	.208	3.718**	.231	3.093**
CHINESE	-	-.053	-1.624*	-.078	-1.937*
OPINION	+	-.015	-0.531	-.047	-1.028
AUDITOR	+	.022	1.214	.036	1.451#
Constant	+/-	-.044	-0.454	-.293	-2.875**
Adjusted R^2		0.720		0.739	
F ratio		198.73		161.68	
Prob > F (Two-tailed test)		0.000		0.000	

@ See Table 7 for variable definitions
**Significant at 1% (one-tailed)
* Significant at 5% (one-tailed)
# Significant at 10% (one-tailed)

Other explanatory variables that are significant in both regressions are LOGASSET, LOGSUBS, INVREC, FOREIGN and CHINESE. The variables are significant at one percent level in the predicted directions. The results are consistent with previous studies done in Malaysia and elsewhere (see for example, Ayoib, 2001 and Rose, 1999). As expected, company size and complexities are the main determinants of audit fees. Similarly, foreign investors are likely to demand higher quality audit and this is reflected in higher audit fee. Unique to the Malaysian audit market, Chinese controlled companies pay lower audit fees than other companies due to the Chinese business practice discussed earlier. However, the variable AUDITOR is not significant for the analysis of all companies and only (weakly) significant when the sample of NAS-purchased companies is utilised. Hence, the evidence of brand name premium is not conclusive.

The variance inflation factors (VIF) in both regressions indicate that the presence of multicollinearity is not serious as VIF does not exceed 2.0 for any of the explanatory variables in the regression (a level of 10 is generally regarded as indicating a significant problem; Marquardt, 1970).

T-test Analysis of NAS Fee and Audit Opinions

A comparison of group means for NAS fee between qualified and unqualified audit opinion is provided in Table 3. The t-test result indicates a (weak) significant different in the means of NAS fee implying the inequality of the sample means between the two groups. In other words, the result shows an evidence of auditors compromising its independence when the clients pay high levels of NAS from the auditors. These univariate result reported in Table 3 is comparable with previous research in other countries (see Wines, 1994 in Australia and Firth, 2002 in United Kingdom).

Table 3: *t*-Test Between Qualified Opinion and Unqualified Opinion (N=819)

	Qualified	Unqualified	t-value	Sig.*
Means	0.89	1.10	-1.524	0.0640
(Standard Deviation)	(1.08)	(1.00)		

* one-tailed test.

Further analysis shows that the results of the audit fee model reported above were not sensitive to different subsamples. However, interesting findings were found when the t-test of audit opinion between NAS- and non-NAS-purchased companies was carried out for Big 5 and non-Big 5 auditees. The mean of LOGNAS between companies that received qualified opinions and companies that received clean opinions was statistically significant at 5% level when a sample of non Big 5 auditees was used. The result was not statistically significant when a group of the Big 5 auditees was used as a sample. The outcome suggests non Big 5 auditors were less independent when issuing audit reports for NAS purchased companies. This is also consistent with the preposition that large auditors are more independent than smaller auditors (DeAngelo, 1981b).

DISCUSSIONS

The study finds a significant positive relationship between audit fees and non-audit fees. This result does not support the theory proposed in the study but it is consistent with previous studies done by Simunic (1984), Palmrose (1986b), Firth (1999), and again by Firth (2002). This means that the result does not support the two theories explained by Simunic (1984), which are "knowledge spillover effect", and "loss leader" theories. As argued by Firth (2002), the contradictory findings might be due to specific events in the company that generated a demand for consultancy services as well as requiring additional audit efforts.

With regards to objective two of the study, the results obtained from the t-test suggest a significant relationship between NAS fees and qualified audit opinions. The results imply that audit opinion is dependent on the amount of NAS fee. Further tests reveal that the different was more prevalent among non Big 5 auditees. It could be argued that small auditors could not resist against management pressure when issuing qualified opinion. Similarly, the non-parametric tests also reveal that companies that purchased NAS tend to have less qualified opinions. This is perhaps an interesting finding because one of the rules in SOX limits the provision of NAS as it seems to be impairing auditors' independence. Similarly, the MIA By Law (On Professional Conduct and Ethics) (revised 2002) calls for audit firms not to accept any appointment if the provision of NAS would create a significant threat to the professional independence, integrity and objectivity of the audit firms.

With regards to the final objective of the paper, the study found that about 63% or 512 out of 819 listed companies in 2002 purchased NAS. However, the proportion of NAS fee to total auditor remuneration is worrying. Almost 90% of the NAS-purchased companies have NAS fee ratio of 5% or more. As noted earlier, if the SOX 2002 of the USA is used as the benchmark, 90% of the auditors in Malaysia are not independent in providing the auditing service. In Malaysia, under the MIA rules, professional independence is considered impaired if total fees arising from NAS to a client is 20 percent or more of the audit firm's total annual fees received for two or more consecutive years. However, unlike the SOX, the rule is silent with regards to the proportion of NAS fees to total fees (audit and NAS fees) for a particular client. Gul and Teoh (1986) reported that confidence of the Malaysian public in the financial reports drops if the NAS is also provided by the incumbent auditors. Teoh and Lim (1996) reported that even the accountants themselves are skeptical if the NAS ratio is more than 50%. This study documents that 21% of the auditors of NAS-purchased companies have more than 60% NAS ratio. It seems that auditors in Malaysia are very dependent on NAS as a major source of revenue.

Taken together, the results of the regression analysis and the t-test results suggest no market wide full-blown problems with regard to auditor independence in the Malaysian market for audit and NAS. However, the findings of positive relationship between NAS fees and clean audit opinions as well as high proportion of NAS fee to total fees are a cause for concerns.

IMPLICATION AND CONCLUDING REMARKS

This study is expected to contribute to the body of knowledge on current situations of non-audit fees and audit fees especially in the developing market. It adds to the small but growing literature on studies of audit pricing and auditors' independence in Malaysia. It also highlights the present situations in Malaysian accounting profession regarding the issue of audit pricing and non-audit fees as well as NAS fee and audit opinion and its implication on auditors' independence. Consistent with prior studies, the present study finds a positive and significant relationship between audit and non-audit fees contrary to the theory available in the literature. Whilst explanations are provided for this discrepancy, further in-depth studies are needed to corroborate these explanations. Perhaps, a longitudinal study could provide a more meaningful analysis in view of phenomenal increase in NAS fee recently.

The study is also expected to help regulators to formulate rules and guidelines in order to improve auditors' independence. For example, the NAS disclosure requirement should specify the location of disclosure as well as the accepted term for the description of non-audit service fee. The disclosure should be made mandatory even if the company does not purchase NAS. It is also recommended that the NAS fee is segregated between recurring NAS and non-recurring NAS. It could be argued that recurring NAS might affect auditor independence more than a single or one time NAS. Similarly, the MIA by laws should be amended to provide a clear guideline on NAS by limiting the NAS based on certain threshold as originated in the US Sarbanes-Oxley Act. The excessive reliance on NAS fees by some auditors as discussed earlier should not be taken for granted. There could be another Enron in the making but the nation cannot afford to have the "Malaysian made Enron" to happen. Whilst independence in-fact is a state of mind of the auditors, the recommendations suggested by this paper might improve the perceptions of users towards auditors' independence. Hopefully, this study will provide a catalyst for all interested parties to work on for the betterment of the accounting profession in Malaysia.

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