AUDITOR INDEPENDENCE IN MALAYSIA

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Abstract

The external auditors have been described as a person who hold the responsibility to express his / her opinion on the fairness of the client's financial statements. They are expected to be independence, not only in fact but also in appearance in conducting their professional work. Lack of independence has caused concern in the community. In this context, the objective of this study is to examine the impact of the degree of competition of audit clients, the provision of non-audit services, the size of the audit firm and audit tenure on Malaysian bank loan officers' perceptions of auditor independence. The perceptions of the loan officers were solicited by distributing questionnaires via drop-off-method which achieved a response rate of 63 per cent. Taken as a whole, the findings of the study suggest that the respondent would be highly confidence with the independence of the auditor if the degree of competition in the audit market is low; the auditor do not provide management consulting services to the same client; the size of the audit firm is large and the audit tenure is less than 5 years. Plausible implications of the findings of the study are presented and areas for future research are also proposed.

AUDITOR INDEPENDENCE IN MALAYSIA

INTRODUCTION

Auditor independence has been a subject of intense empirical research. Most of the research has been primarily concerned with identifying those situations in which the auditor might not be perceived to be independent. Carmichael and Swieringa (1968) argue that independence is a quality of auditor professionalism. Independence is defined as the auditor's ability to resist client pressure (Knapp, 1985; Pany and Reckers, 1980; Pearson and Ryan, 1982) or the auditor's ability to act with integrity and objectivity (McKinley et al., 1985; Pany and Recker, 1988).

The objective of this study is to examine the impact of the degree of competition of audit clients, the provision of non-audit services, the size of the audit firm and audit tenure on Malaysian bank loan officers' perceptions of auditor independence.

This study is considered as significant because it focuses on the perceptions of bank loan officers regarding auditor independence. Their views are relevant because they are representing the creditors. It is hope that the findings can give some information to the professional profession, particularly the auditor, to improve the level of their independence.

LITERATURE REVIEW

The issue of auditor independence from the perspective of loan officer has been the central point in some researches, namely (Shockley (1981); Knapp (1985); Gul (1989); Bartlett (1993).

Shockley, (1981) examined the perceived effects of competition, MAS, audit-firm size, and tenure on the risk that audit independence may become impaired. The results indicated that audit firms operating in highly competitive environments, firms providing MAS, and smaller audit firms are perceived as having a higher risk of losing independence. However, the audit firm's tenure with a given client is found not significant.

Knapp (1985) study on how certain contextual factors in auditor-client conflicts affect the perceived ability of auditors to resist client pressure. He identified that there were four factors that affect financial statement users' perceptions of audit conflicts outcomes: nature of conflicts issue, client's financial condition, provision of MAS by the audit firm, and the degree of competition in the audit services market. The results indicated that a client in good financial condition is perceived as being more likely to obtain its preferred outcome to an audit conflict than a client in poor financial condition.

Gul (1989) examined the impact of audit committees, financial condition of the client, management advisory or consulting services (MAS), competition for audit clients and size of the audit firm on a sample of New Zealand bankers' perceptions of auditor independence. The results suggest that MAS, competition and size-affected perceptions of auditor independence with MAS and competition had positive effects on auditor independence while size had a negative effect on perceptions of auditor independence.

In addition, Bartlett (1993) conducted a study on the issue of the nature of independence construct; whether the perception of an auditor's independence affected by knowledge of the size of the audit fee in comparison to the total billings managed by the individual auditor; and the effect of a respondent's knowledge of accounting and auditing have on the level of perceived independence.

From the preceding discussion, the study concluded that there are limited study undertaken on the issues of auditor independence from the perspective of creditors, particularly in developing country like Malaysia. This paper attempts to extend the literature by examining the perceptions of the Malaysian bank loan officers, cum creditors, on the issue of auditor independence.

RESEARCH METHODOLOGY

i- **Instrument**

A questionnaire was developed to gather the required data. The questionnaire was replicated from those adopted by Gul (1989) and Shockley (1981) with some amendment made to suit the purpose of the study. Initial version of the questionnaire was sent to 60 respondents. Following to the comments received, minor adjustments were made to the questionnaire. The final version of the questionnaire contains two sections. Section A requests for the demographic background of the respondents, whereas Section B examines the impact of the degree of competition of audit clients, the provision of non-audit services, the size of the audit firm and audit tenure on Malaysian bank loan officers' perceptions of auditor independence. Section B requests the respondents to indicate their opinion based on a scale numbered from 1 to 7. The number represents the respondents' subjective judgement of the confidence that they have in the auditor's independence. (i.e. if the respondent has no confidence in the audit firm's independence he / she should circle the number 1, and when he / she have great confidence in the auditor's independence he / she should circle the number 7. Circling a number between 1 and 7 should indicate intermediate levels of confidence).[1] Generally, the scale indicates: 1 as no confidence; 2 as very little confidence; 3 as little confidence; 4 as confidence; 5 as highly confidence; 6 as very highly confidence and 7 as extremely confidence.

ii- **Respondents**

The population of this study is Malaysian bank loan officer. As at the third quarter of 2001 there were 27 bank operating in Malaysia. The study randomly selects a sample of 100 bank loan officers who work with those banks that operating in Klang Valley. The study focuses in this area mainly because the Capitol City of Malaysia is located in this area. Hence, numerous banks are operated here.

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[1] The questionnaire does not provide the details of the scale in order to avoid from influencing the respondents. Therefore, the respondents are free to give any rate based on their own perceptions.

Questionnaires were distributed via drop-off-method (i.e. hand delivery of self-administered questionnaires, followed by personal collection). However, of 100 questionnaires distributed, only 68 were able to be collected and 5 of it were incomplete. Therefore, the response rate for this study is 63 %.

DATA ANALYSIS

i- **Demographic**

Analysis of the demographic reveals that 47 (74.6 %) of the respondents were from companies listed on the KLSE whereas 16 (25.4 %) were from unlisted companies. Majority of the companies, 33 (52.4 %) have total assets more than RM 5 billion; 16 (25.4 %) from RM 1 billion to RM 5 billion; 6 (9.5 %) from RM 750 million to RM 1 billion; 3 (4.8 %) from RM 500 million to RM 750 million; 1 (1.6 %) from RM 250 million to RM 500 million and 4 (6.3 %) have total assets less than RM 250 million. In terms of net profit before tax and extra-ordinary items, most of the companies, 32 (50.8 %) have more than RM 250 million net profit; 12 (19.0 %) have from RM 100 million to RM 250 million; 3 (4.8 %) have from RM 75 million to RM 100 million; 5 (7.9 %) have from RM 50 million to RM 75 million; 4 (6.3 %) have from RM 25 million to RM 50 million and 7 (11.1 %) have less than RM 25 million. Majority of the companies, 55 (87.3 %) indicated that their auditors are the Big 5 firm and only 8 (12.7 %) audited by the Non Big 5 firm.

The study further asked the respondents regarding their operating activities. The results are as follows:

Table 1: Operating activities

	n	%
Loan applicant should present an audited financial statement.		
Yes	58	92.1
No	5	7.9
Have panel audit firm.		
Yes	39	61.9
No	23	36.5
Missing value	1	1.6
Years in the current position.		
< 1 year	2	3.2
1 year – 3 year	14	22.2
4 year – 6 year	25	39.7
7 year – 9 year	11	17.5
10 year – 12 year	8	12.7
> 12 year	3	4.8
Experience in disapproving a loan application due to lack of auditor independence.		
Yes	22	34.9
No, never have.	40	63.5
Missing value	1	1.6

It appears that most banks in Malaysia require loan applicant to submit an audited financial statements if they want to apply loan. 39 or 61.9 % of the respondents said that their bank have panel audit firm. This means that loan applicants are required to approach these audit firms to examine their financial statement. Majority of the respondents; 50 (78.9 %); have 1 to 9 years of experience in the current position; loan officer. Meanwhile, only 22; 34.9 %; of them had experience disapproving loan application due to lack of auditor independence. The study assumes that this response might be from respondents whose banks do not have panel audit firm. This is because we believe that when a bank had chosen a panel audit firm meaning that there must be some degree of confidence had been given on the independence of that particular panel audit firm.

Mean Analysis

The study conducts a mean analysis to determine the degree of importance of each the scenarios in influencing the audit quality. The study has decided that any factors with the mean values in the range of 0.0 to 1.0, as no confidence; in the range 2.1 to 3.0, as little confidence; 3.1 to 4.0, as confidence; 4.1 to 6.0 as highly confidence and 6.1 to 7.0 as extremely confidence.

Table 2: Mean analysis

Scenario	Mean
16	5.7619
15	5.5079
6	5.2742
14	5.1429
10	5.1111
11	5.0794
12	5.0476
8	4.9841
13	4.9365
9	4.8710
7	4.6984
5	4.4603
4	4.1746
3	4.0952
2	3.9841
1	3.7619

Table 2 lists the scenarios according to the highest mean score to the least mean score. Surprisingly, the results show that none of the scenarios scores lower than 3.0 indicating that the respondents were at least confidence on the independence of the auditors in the given scenarios. Scenario 16 scores the highest mean, which is 5.2742. It appears that bank loan officer have highly confidence with auditor's independence if degree of competition among accounting firms in the respondents area is low; the auditor do not render management advisory services (MAS) to the bank; the size of the accounting firm is large and the auditor's tenure is less than 5 years.

Meanwhile, the lowest score is scenario 1 with a mean of 3.7619. The analysis reveals that the respondent only confidence on the auditor independence if the degree of competition among the accounting firms is high; the auditor also render MSA to the bank; the accounting firm is small and the auditor's tenure is more than 5 years.

The study also looks at the similarity of the characteristics of the accounting firms that scores means more than five. The analysis of table 3 reveals that respondents were highly confidence on the auditors' independence if the accounting firm where the auditors work with is large and if the audit tenure is less than five years. This may be due to the fact that large accounting firms generally have many resources and therefore are perceived to be independent from any party. They are not in the capacity to have difficulties of getting new clients if they withdrawn from any risky engagement (i.e. engagement that has the potential that can impair the auditor independence; e.g. audit a company where the auditor's son is working in an audit-related function.) In addition, auditors who had an engagement for more than five years are perceived not independence by the respondents. This may due to the fact that the long relationship between client and auditor may lead to some bias for instance auditor may try to fulfill the client's need, which might not be in the best interest of the shareholders. Auditors may also drop off thorough evaluation of internal controls and client's accounting system. For degree of competition among accounting firms, it seems that the loan officers were highly confidence on the auditors' independence if the competition degree is low indicating that auditors are not aggressively increasing their client numbers, which by doing so might impair their independence. Finally, the respondents were highly confidence on the auditors' independence if auditors do not provide MAS to the client. This is because if the auditors audit and at the same time provide MAS to the same client, auditor may be bias in their work since they do not want to losing client.

Table 3
Characteristics of accounting firms with high mean scores

Scenario	Degree of Competition	MAS	Size of accounting firm	Auditors' tenure
16	Low	No	Large	≤ 5
15	Low	No	Large	> 5
6	Low	Yes	Small	≤ 5
14	Low	Yes	Large	≤ 5
10	High	Yes	Large	≤ 5
11	High	No	Large	> 5
12	High	No	Large	≤ 5

The relationship between the bank size and level of confidence

Linear regression is used to analyse whether the level of confidence on the auditors independence based on the audit firms' characteristics[2] will differ according to the size of the bank (indicator is the total assets; the larger the total assets the larger is the size of the bank). The study only analysed scenario 16. This study tries to justify whether the larger the bank is the greater confidence the loan officer would be on the auditors independence based on the audit firms' characteristicse. The regression analysis is used to determine the linear relationship between two variables. In the correlation the level of confidence as the dependent variable and the size of the bank as the independent variables.

ANOVA test was done to examine the significance mean differences. If the significant level is below than 0.05, it can be presumed that there is a significant relationship between the two variables. From Table 4, the significance score is 0.056 indicating that the level of confidence do not have a statistically significant relationship with the size of the bank.

Meanwhile, the correlation coefficient indicates the strength and direction of the relationship between the level of confidence and the size of the bank. A positive correlation means that the larger the bank size, there will be an increase in the level of

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[2] Characteristics of the audit firm based on scenario 16: degree of competition among accounting is low; the auditor do not render management advisory services (MAS) to the bank; the size of the accounting firm is large and the auditor's tenure is less than 5 years.

confidence on the auditors independence based on the audit firms' characteristics. If there is a negative correlation, an increase in the bank size will result in a decrease in the level of confidence on the auditors independence. As reported in Table 5, the coefficient is 0.206. This means that for every 1% increase in the bank size, there is a positive 0.206 change in the level of confidence on the auditors independence. The possible justification for this is that the larger the bank is the more susceptible the bank would be to the characteristics of the audit firm that may influence the auditors independence. This is because the respondents believe that it is important for the auditor to be independence and this may enhance the credibility of the bank's customers audited financial statements.

Finally, R-square analysis is conducted and the result is presented in Table 6. The R-square is 0.059 indicating that 5.9% of the variance in scenario 16 is explained by the variation in the bank size. Even though the dependent variable is affected by the independent variable, the variance is too small to presume that the bank size is significantly affecting the level of confidence on the auditors independence based on the audit firms' characteristics.

In conclusion, this linear regression analysis shows there is a relationship between level of confidence on the auditors independence based on the audit firms' characteristics with the bank size, though it is not significant. In addition, the level of confidence does increase when the size of the bank increases. Hence, the study conclude that the larger the bank, the more confidence they would be on the independence of the auditor based on characteristics of the audit firm in scenario 16.

Table 4: ANOVA[b]

Model		Sum of squares	df	Mean square	F	Sig.
1	Regression	5.237	1	5.237	3.794	0.056[a]
	Residual	84.192	61	1.380		
	Total	89.429	62			

a. Predictors: (constant), Asset (bank size)
b. Dependent variable: characteristics of audit firm in scenario 16

Table 5: Coefficients[a]

Model		Unstandardised coefficients		Standardised Coeffiecients	t	Sig.
		B	Std. error	Beta		
1	(Constant)	4.728	0.551		8.576	.000
	Asset	0.206	0.106	0.242	1.948	0.056

a. Dependent variable: characteristics of audit firm in scenario 16

Table 6: Model summary

Model	R	R Square	Adjusted R Square	Std. Error of the estimate
1	.242[a]	0.059	0.043	1.1748

a. Predictors: (Constant), Asset (bank size)

Conclusion

To conclude, this study aims to examine the impact of the degree of competition of audit clients, the provision of non-audit services, the size of the audit firm and audit tenure on Malaysian bank loan officers' perceptions of auditor independence. The result of the study appeared to suggest bank loan officers would be highly confidence with the independence of the auditor if the degree of competition in the audit market is low; the auditor do not provide management consulting services to the same client; the size of the audit firm is large and the audit tenure is less than 5 years.

This research is of an explanatory character and of limited scope since the sample taken is small and hence the results reported here might be limited in terms of generalizability. Despite these limitations, the findings of this study do provide a platform for future investigation and diagnosis. Future areas of research may be conducted in terms of the association between auditor independence and audit cost.

It is hope that the findings can give some evidence to the audit firm, in particular, of the importance to maintain independence, not only in fact but also in appearance.

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