

AUDITORS' INDEPENDENCE AND AUDITOR ETHICAL JUDGEMENTS: EVIDENCE FROM MALAYSIA

Fahimah Mohamad Tahir

Department of Accounting, Universiti Tenaga Nasional,
Kampus Sultan Haji Ahmad Shah, 26700 Muadzam Shah, Malaysia
fahimahmohdtahir@yahoo.com

Masdiah Abdul Hamid

Department of Accounting, Universiti Tenaga Nasional,
Kampus Sultan Haji Ahmad Shah, 26700 Muadzam Shah, Malaysia
masdiah@uniten.edu.my

ABSTRACT

Within the auditing profession, independence and ethical behavior of the auditors are very much related. The auditors' conduct could determine whether they are seen or perceived to be independent in their action. This study aims to examine the relationship between auditor's independence and ethical judgment, in Malaysia context. An experiment with 116 auditors and shareholders is conducted to examine whether changes in auditors' independence threats will consistently increase the auditors' ethical judgments level. This study includes four types of independence threats namely self-interest, familiarity, self-review and intimidation threats to observe the effects on auditors' ethical judgments. The findings revealed there is significant negative relationship between intimidation threat and ethical judgment and insignificant positive relationship between other types of auditors' independence threats on ethical judgments. This study suggests that auditor likely to diminish their independence if they being threaten with dismissal or replacement of the professional accountant in business or relation to a client engagement.

Keywords: Auditor independence, Ethical judgment, Self-interest threat, Familiarity Threat, Self-review threat, Intimidation threat

INTRODUCTION

Audit quality is very important to increase financial statement user's trust on the financial reporting. However, some lack in the auditor independence and experience had decreased user's trust on the auditors. In fact, scandal occurred in Enron Corporation and World Com in USA around 2001 and 2002 have deteriorated public trust on audit firm due to lack of audit independence. Enron case study shows that there is a link between non-audit services and

audit independence suggest that the auditor independence should be regulated by policy makers, governments and professional accounting bodies to ensure adequate regulation of the capital market (Senyigit, 2013). Johari, Sanusi, Rahman & Omar (2013) state that independence threats are situations, actions or relationships that are likely to affect the auditor's ability to comply with the fundamental principle of ethics. This shows that auditor's independence had a significant effect towards the audit quality and ethical judgment. Because of the important result of an audit process, the auditor must have the quality in accordance with the generally accepted auditing standard (GAAS) when accumulates and evaluates the audit evidence. Auditor need to give audit opinion based on the professional judgments to attract user's trust. It is important to auditors need to identify and manage auditors' independence to remains unqualified audit report. As practitioner independence, auditor has to perform audit works with the ability of the individual practitioner to maintain proper attitude in the planning audit program. The performance of auditors' verification work and preparation of report is important for the shareholder to look the financial statement and, to presume the auditor as independent party to have adequate experience and good accountability. This will affect the shareholders' perception about the quality of the audit service especially when users need to make decision.

According to Johari, Sanusi, Rahman& Omar (2013), in exercising duties, auditors are being exposed to various independence threats which might influence them in making judgments. Independence threats are situations, actions or relationships that are likely to affect an auditor's ability to comply with the fundamental principles of ethics. For example, the independence threats such as auditing own works resulting from the provision of non-audit services, economic fee dependence and familiarities threats developed from lengthy auditor tenure have been alleged to contribute to the erosion of auditor independence. With the wave of crises in the early 2000, the auditor independence was put in the spotlight which has continually threatened the integrity of the entire profession. The study aims to provide further understanding of the factors influencing auditor independence from the perspective of auditors and users in Malaysia. It is important to auditors need manage their independence to remains the quality of audit services. In addition, this research also offers important input to serve as a strong basis for the profession to establish policies relating to auditor independence, particularly in Malaysia and assist policy maker towards the harmonisation of auditing standard. Therefore, the objectives of this study are to examine the effect of auditors' independence threats (self-interest, familiarity, self-review and intimidation) on auditors' ethical judgments in Malaysia perspective.

LITERATURE REVIEW

Auditor's Independence

According to the By-Law issued by Malaysian Institute of Accountants (MIA), independence requires both, which is independence of mind and independence in appearance (MIA, 2011). The others said that, auditor independence is as the heart of the integrity of the audit process where maintaining the independent audit function is obligatory for auditors and required by the standard of profession (Chen, Elder, & Liu, 2005). According to Abu Bakar, Abdul Rahman, and Abdul Rashid (2005), they only focused on independence in appearance such as the factors which have significant influence on auditor independence since independence in fact is unobserved.

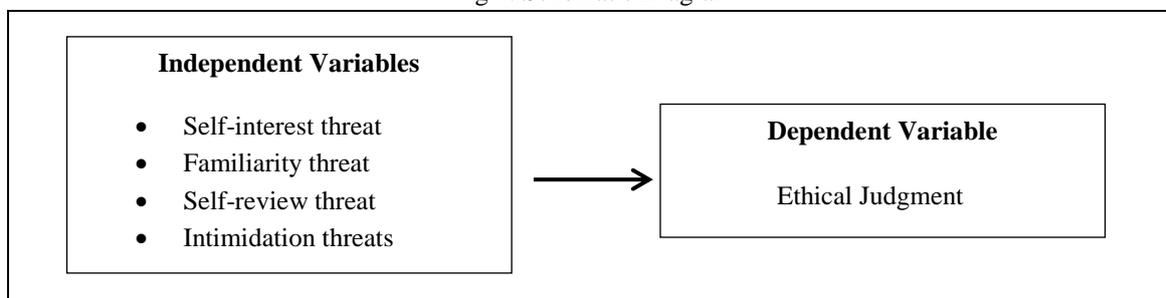
Ethical Judgment

According to Johari, Sanusi, Rahman & Omar (2013), the ethical judgment is the stage where a person has recognized the ethical issues and considers alternatives that best solve the problem to attain the most beneficial outcome. The ethical judgments process is theorized to lead an individual to the establishment of an ethical intention where an individual formulates an intention to act ethically based on an assessment of the right choice versus other alternatives (Johari et al., 2013). According to Hunt and Vitell (1986), ethical judgment is the process of considering several alternatives and choosing the most ethical alternative. Ethical judgment is the process by which an individual determines that one alternative is morally right and another alternative is morally wrong.

Theoretical Framework

In order to better visualize our hypotheses, we have constructed our own model based on the previous research to test the relationship between auditor independence threats measurement, namely self-interest, familiarity, self-review and intimidation threats, towards ethical judgment as follows:

Fig 1: Schematic Diagram



Hypotheses Development

It is a threat that a financial or other interest will inappropriately influence the auditors

judgment or behavior and it's commonly called a 'conflict of interest' which may inappropriately influence judgment or behavior. Johari et al., (2013) found of that when the total fees from an audit client represents a large proportion of the total revenue of a firm, financial dependence and the concern over losing the client may give rise to a self-interest threat. This study use a term of "client importance" as to portray the fee dependence of auditors on audit client and the client importance may influence the auditors.

H1: Self-interest threat (client importance) is significant negative associated relationship with auditor's ethical judgments.

Familiarity threat is a risk that the auditor may be over influenced by the client's personality and qualities, which are auditor, consequently become too sympathetic to the client's interest through. For example, auditor has too long and too close relationships with client personnel. Familiarity threat can be created because the close relationship might have potential to affect the auditor's independence. Which is may result in excessive trust in the client and insufficient objective testing of his representations.

H2: Familiarity threat (long association of senior personnel with audit clients) is significantly negative associated with auditors' ethical judgments.

This threat relates to the difficulty in maintain objectivity in conducting self-review procedures. For example, when auditors involve in decision making, or take part in decisions, that should be taken wholly by the audit client's management. Otherwise, when make any judgment related to previous audit or non-audit work performed by the auditor or his firm needs to be challenged or reevaluated to reach a conclusion on the current audit.

H3: Self-review threat (preparing accounting records, financial statements and management advisory) is significantly and negatively associated with auditors' ethical judgments.

For this types of threats to compliance can occur when an accountant is deterred from acting objectively due to threats, actual or perceived. Normally, this situation happens when a professional accountant or his close family member may be threatened with dismissal or replacement over disagreement about the application of accounting policies or preparation of financial statement. In the public practices, such threat could arise when an auditor is being threatened with litigation or is being pressured to reduce inappropriately the extent or work to be performed in order to reduce fees.

H4: Intimidation threat (auditor is being threatened or pressured) is significant negative associated with auditors' ethical judgments.

RESEARCH METHOD

Sample Selection

The subject is auditors and shareholders in Malaysia context. Auditor is selected as a sample because they involve directly in the examination of financial statement. Besides, the auditor also involves in providing opinion and value added to the company. Next, shareholder is selected as a sample in this study because they are representing not only as investor but also the interest users of financial statement. Shareholders are qualified person in making judgments because they are involve in investment decisions. According to Abu Bakar (2009), they are among the sophisticated financial statement users who would understand the importance of the independent audit function. Responses from shareholder are to views of the investor's group for the purpose of making investment decisions.

Data Collection

Data collected using the face to face and mail survey methods. This method is chosen not only because it is quick, inexpensive, efficient and accurate but to avoid bias from the respondent. In this study, since perceived independence represents opinions of people, the survey method, thus, can be considered as the most appropriate method.

For the purpose of this study, 200 questionnaires were distributed to the selected respondent. 100 questionnaires distribute to shareholder administered to public listed company and private company and 100 questionnaires distributed to Big4 and non-Big4 audit firm accordingly. Auditors and shareholders were randomly selected and invited to participate in the study since our sampling design for our research is non-probability sampling, which is sampling is determine by convenience sampling. Out of the 200 questionnaires, 135 were returned representing an overall response and 116 questionnaires are completed that will use in our research after removing all incomplete questionnaires. To test the hypothesis, we collect questionnaire survey data from shareholders in Public Listed Companies (PLCs) and private company in four areas which covered Peninsular Malaysia. Those four areas selected are Kuala Lumpur, Penang, Johor Bahru and Terengganu. Kuala Lumpur is selected as it represents central region, Penang is represent northern region, Johor Bahru represent southern and Terengganu represent east coast region of Peninsular Malaysia.

RESULTS AND ANALYSIS

Descriptive Analysis of the Participants

The frequency technique is used to describe the statistic of categorical variable. Based on table 1 as shown below, there are 52 of shareholder (44.8%) and 64 of auditor (55.2%) in the sample that giving a total of 116 respondent. The result also shows that there are 46 males (39.7%) and 70 female (60.3%) in the sample that giving a total of 116 respondents. Even though the number of respondents regarding the gender is not equal in size, this is however did not affect the research question of this study. Other variables that been categorized include race for four group which is Malay (69.8%), Chinese (21.6%) and Indians (8.6%), age for seven group which is below than 25 years (21.6%), 26 to 30 years(11.2%), 31 to 35 years (25.6%), 36 to 40 years (7.8%), 41 to 45 years (10.3%), 46 to 50 years (13.8%), more than 51 years (9.5%). Age of most of the respondent is between 31 to 35 years. Means, their perception is reliable for this study because they have more experience. The other information includes education of shareholder and auditor which is Diploma (21.6%), Bachelor's Degree (42.2%), Master's Degree (14.7%), PhD (4.3%), and others (17.2%). In addition, the qualifications of respondent are MIA (5.2%), MICPA (0.9%), ACCA (13.8%), none (63.8%) and others (16.4%). For public and non-public accounting shows that most of the respondents involved in non-public accounting which represent 43.1% as compared to public accounting represent 16.4%. The next information is current experience which the higher percentage is 4 to 6 years (39.7%) and the lower percentage is less than 1year (6.9%) and as for firm category its shows that none is higher percentage. The age of therespondents ranged from 31 to 35 years with a mean value of age is 3.53 and a standard deviation of 1.993.

Table 1: Demographic Characteristics

Item	Overall (N=116)		
	Frequency	Percent (%)	Mean
Age	Below than 25 years	25	21.6
	26 – 30 years	13	11.2
	31 – 35 years	30	25.6
	36 – 40 years	9	7.8
	41 – 45 years	12	10.3
	46 – 50 years	16	13.8
	More than 51 years	11	9.5
Gender	Male	46	39.7
	Female	70	60.3
Race	Malay	81	69.8
	Chinese	25	21.6
	Indian	10	8.6
Highest Academic Qualification	Diploma	25	21.6
	Bachelor's Degree	49	42.2
	Master's Degree	17	14.7

	PhD	5	4.3	
	Others	20	17.2	
	MIA	6	5.2	
	MICPA	1	0.9	
Professional Qualification	ACCA	16	13.8	4.66
	NONE	74	63.8	
	Other	19	16.4	
	Public Accounting	19	16.4	
	Non Public Accounting	50	43.1	
Past Experience	None	42	36.2	1.95
	Missing	5	4.3	
	Less than 1 Years	8	6.9	
	1-3 Years	25	21.6	
Current Experience	4-6 Years	46	39.7	2.97
	More than 6 Years	37	31.9	
	Shareholder	52	44.8	
Current position	Auditors	64	55.2	9.04
	Big-4	8	6.9	
	Non-Big-4	37	31.9	
Firm category	None	71	61.2	2.54

Reliability Statistics

Base on table 2 shown below, result for the Cronbach's alpha is 0.80, suggesting very good internal consistency reliability for the scale with this sample. Value above 0.7 are considered acceptable, however, value above 0.80 are good. According to Pallant (2002) the satisfaction of Life Scale has good internal consistency, with Cronbach's Alpha is 0.85. The alpha value of this study is more than the satisfaction level. Therefore, this scale can be considered have very good internal consistency.

Table 2: Table of Reliability statistics

Cronbach's Alpha	Cronbach's Alpha Based on Standardized Items	N of Items
0.802	0.807	4

Correlation Analysis

A total of 200 distributed questionnaires, there are 116 answered and complete questionnaires returned by respondent about their perceptions towards auditor's independence. The descriptive analysis used to describe the characteristics of variables used of the sample in the study. The frequency technique is used to describe the statistic of categorical variable. Based on table 3 as shown below, there are 52 of shareholder (44.8%) and 64 of auditor (55.2%) in the sample that giving a total of 116 respondent. The result also shows that there are 46 males (39.7%) and 70 female (60.3%) in the sample that giving a total of 116 respondents. Even though the number of respondents regarding the gender is not equal in size, this is however did not affect the research question of this study. Other variables that been categorized include race for four group which is Malay (69.8%), Chinese (21.6%) and Indians (8.6%), age for seven group which is below than 25 years (21.6%), 26 to 30 years(11.2%), 31 to 35 years (25.6%), 36 to 40 years (7.8%), 41 to 45 years (10.3%), 46 to 50 years (13.8%), more than 51 years (9.5%). Age of most of the respondent is between 31 to 35 years. Means, their perception is reliable for this study because they have more experience. The next information is current experience which the higher percentage is 4 to 6 years (39.7%) and the lower percentage is less than 1year (6.9%) and as for firm category its shows that none is higher percentage. The age of therespondents ranged from 31 to 35 years with a mean value of age is 3.53 and a standard deviation of 1.993. Meanwhile, mean score for gender, race, highest education level, professional qualification, past experience, current experience, current position and firm categories are, 0.40, 1.39, 2.53, 4.66, 1.95, 2.97, 9.04 and 2.54 respectively. Wherease for standard deviation score, result below shows, 0.491, 0.643, 1.348, 1.231, 0.642, 0.903, 7.094 and 0.624 respectively.

To test the hypothesis, this research use spearman's rank order correlation. Table 3 shows the correlation between independence threats and ethical judgment. This study purposes to examine the relationship between independence threat and ethical judgment, in Malaysia context. The analysis shows that Spearman correlation coefficient value is -0.305 for intimidation threat. It is indicates a negative correlation between intimidation threat and ethical judgment. The result shows that only intimidation threat is significant at the level 0.01 percent. This suggests that intimidation threat can influence auditor's ethical judgment when he or she being forced by client or litigation. Then, spearmen correlation for self-review threat between ethical judgment is 0.019 that shows a positive correlation coefficient and not significant result ($p > 0.05$). Besides, the association between self-interest threat and ethical judgment, the correlation coefficient is 0.168. Lastly, as for familiarity threat and ethical judgment, the correlation coefficient is 0.076. All correlation coefficient appear in positive sign and not significant ($P > 0.05$). Therefore, there is no significant association between self-review threat, self-interest threat and familiarity threat to ethical judgment. Johari et al., (2013) The result shows that all the independence threats under study provide significant

positive influence on the auditors' ethical judgments. In addition, the results also highlighted the positive significant effect of self-review threat arising from the non-audit services on the auditors' ethical judgments. From the findings it is advocated that in such situations, auditors acknowledge the effect of this threat in their ethical judgments. This study also found a significant interaction effect between self-interest threat and familiarity threat which indicates that more threats will encourage the auditors to behave more ethically. Result from previous research is different with our result. As hypotheses posted earlier, these studies only accept hypothesis 4 and reject hypotheses 1, 2 and 3. Furthermore, this result provides a new insight to auditing profession to enhance their independence and simultaneously enhancing the audit quality in Malaysia.

Table 3: Spearman's correlation between Independence Threats and Ethical Judgment

		Ethical Judgment	Self-review threat	Self-interest threat	Familiarity threat	Intimidation threat
Ethical Judgment	Correlation Coefficient	1.000				
	Sig. (2-tailed)	.				
Self-review threat	Correlation Coefficient	.019	1.000			
	Sig. (2-tailed)	.839	.			
Self-interest threat	Correlation Coefficient	.168	.658**	1.000		
	Sig. (2-tailed)	.071	.000	.		
Familiarity threat	Correlation Coefficient	.076	.598**	.616**	1.000	
	Sig. (2-tailed)	.419	.000	.000	.	
Intimidation threat	Correlation Coefficient	-.305**	.110	-.116	.083	1.000
	Sig. (2-tailed)	.001	.242	.217	.376	.

Notes: ** Correlation is significant at the 0.01 level (2-tailed); * Correlation is significant at the 0.05 level (2-tailed).

CONCLUSION

The auditor independence is very important for the users of the financial statements. The more independence of auditor has, the greater confidence among the public towards work and opinion. Out of 200 distributed questionnaires, there are 116 answered and complete questionnaires returned by respondent about their perceptions towards auditor's independence. In summary, this study is developed to examine the relationship between auditors' independence and ethical judgment in Malaysia, where comprises from four types of threat such as self-review threat, self-interest threat, familiarity threat and intimidation threat. Based on findings, there is significant negative association between intimidation threat and ethical judgment. Therefore, this study found that the high pressure from audit client and

litigation could affect the auditor in making their professional judgment. These results also consistent with auditing standards on impairing auditor's independence where the auditor tends to diminish their independence if they being threaten with dismissal or replacement of the professional accountant in business or relation to a client engagement. In litigation perspective, the auditor will more careful about their future, hence likely to follow the audit client. For this study to be more effective in the future, it is necessary to consider some other suggestion for future research as this study have only provide limited information on the relationship between auditor's independent and ethical judgment in Malaysia. Firstly, future research should expand their segmentation because in this study it only consists four states that are Kuala Lumpur, Johor, Penang, and Terengganu, so that there is limitation in gathering useful information about the auditor's independence. Future research also should distribute questionnaire to all Peninsular Malaysia including Sabah and Sarawak.

REFERENCES

- Abu Bakar, NB, Abdul Rahman, A & Abdul Rashid, HM. (2005). Factors influencing auditor independence: Malaysian loan officers' perceptions', *Managerial Auditing Journal*, 21, pp. 621-35.
- Akaah, I. a. (1994). The influence of personal and organizational values on marketing professionals' ethical behaviour. *Journal of Business Ethics*, 13(6),417-430.
- Al-Ajmi, J & Saudagaran, S. (2011). Perceptions of auditors and financial-statement user regarding auditor independence in Bahrain', *Managerial Auditing Journal*, 26(2), pp:130-160.
- Alleyne, P. A. (2006). Perceptions of auditor independence in Barbados. *Managerial Auditing Journal*, 21(6), 621-635. .
- Alleyne, PA, Devonish, D & Alleyne, P. (2006). Perceptions of auditor independence in Barbados', *Managerial Auditing Journal*, 21, 621-635.
- American Institute of Certified Public Accountants.(1991). AICPA Professional Standards 1 & 2. New York: AICPA. (s.d.).
- Anichebe, A. S. (2010). Auditor Independence in the Global Environment' *Journal of Certified National Accountants of Nigeria*, A Quarterly *Journal of National Accountants of Nigeria*, July-September, 41-44.
- Auditing Practices Board. APB. (2009). Issues a Consultation Paper on Firms Audit Firms Providing Non-Audit Services to Listed Companies That They Audit. (2009).
- Bamber, E. M., & Iyer, V. M. (2007). Auditors identification with their clients and Its effect on auditors objectivity. *Auditing*, 26(2), 1-24.

Beattie, V., Brandt, R., & Fearnley, S. (1999). Perceptions of auditor independence: U.K.evidence. *Journal of international Accounting, Auditing & Taxation*, 8(1), 67-107.

BY- LAWS (on professional ethics, conduct and practice) of the Malaysian Institute of Accountants. (2011). . (s.d.).

Chen, K. Y., Elder, R. J., & Liu, J. (2005). Auditor independence, audit quality and auditor-client negotiation outcomes: Some evidence from Taiwan. *Journal of Contemporary Accounting & Economics*, 1(2), 119-146. .

DeAngelo, L.E. (1981). "Auditor Size and Audit Quality", *Journal of Accounting and Economics*, 3, 183-199.

Dreike, EM & Moeckel, C. (1995). Perceptions of senior auditors: ethical issues and factors affecting actions', *Research on Accounting Ethics*, 1, 331-348.

Hauke J., Kossowski T. (s.d.). Comparison of values of Pearson's and Spearman's correlation coefficient on the same sets of data. *Quaestiones Geographicae* 30(2), Bogucki.

Hunt, S.D. and S. Vitell,. (1986). A general theory of marketing ethics. *Journal of Macromarketing*, 6(1), 5.

Jenkins, J.G. &Krawczyk, K. . (2002). The Relationship between Non-Audit Services, and Perceived Auditor Independence.*Journal of Business and Economic Perspectives*, Fall/Winter,:25-36.

Knapp, M. (1985). "Audit conflict: An Empirical Study of the Perceived Ability of Auditors to Resist Management Pressure", *The Accounting review*,60(2),202-211.

Lin, KZ & Fraser, AM. (2008). 'Auditors' ability to resist client pressure and culture: perceptions in China and the United Kingdom', *Journal of International Financial Management and Accounting*,19(2), 161-183.

Lowe, D.J., Geiger, M.A. and Pany, K. (1999). 'The Effects of Internal Audit Outsourcing on Perceived External Auditor Independence; Auditing: A *Journal of Practice & Theory*, 18 Supplement, 7-26.

Mautz, R. K. and Sharaf, H. A. . (1961). The philosophy of auditing; Florida, American Accounting, Association, Monograph Series (6) .

Mednick, R. . (1990). Independence: let's get back to basics. *Journal of Accountancy*, January.pp:86-93.

Moore, DA, Tetlock, PE, Tanlu, L & Bazerman, MH. (2006). 'Conflict of interest and the case of auditor independence: moral seduction and strategic issue cycling', *Academy of Management Review*, 31, 10-29.

Moreno, K & Bhattacharjee, S. (2003). 'The impact of pressure from potential client business opportunities on the judgments of auditors across profession', *The Accounting Review*, 56(4), 785-800.

Muijs, D. . (2004). *Doing quantitative research in education with SPSS*. London: Sage Publications. .

Nieschwietz, R. W. (2009). Perceptions of auditor independence: evidence from CPAs', loan officers, and the general public. *Academy of Accounting and Financial Studies Journal Publisher*, 13(3), 1-21.

Nur Barizah , A.B & Maslina , A. (2009). Nur Barizah , A.B & Maslina , A. Auditor Independence : Malaysian Accountants' Perceptions *International Journal of Business and Management* , 4(12).

Razana, J. J., Zuraidah, M. S., Rashidah, A. R. & Normah, O. (2013). Auditor independence, experience and ethical judgments: The case of Malaysia. *Journal of Business and Policy Research*, 8(1), 100-119.

Shockley, R. &. (1983). A behavioural investigation of supplier differentiation in the market for audit. *Journal of Accounting Research*, 545-564.

Smith, R. &. (2002). (2002, July 30). Feds eye Merrill's Enron deals. *The Wall Street Journal*. Retrieved from <http://www.msnbc.com/news/787517.asp>.

Sparks, J.R. and Y. Pan,. (2010). Ethical judgments in business ethics research: Definition, and research agenda. *Journal of Business Ethics*, 91(3), 405-418.

The Treasury. (2010). *Audit Quality in Australia : a Strategic Review*, Commonwealth of Australia, retrived from <http://www.ag.gov.au/cca>.

Thornton, J., Reinstein, A., Miller, C. (2003). Non-audit services and perceived auditor independence. *Journal of Accounting and the Public Interest* (3), 36-57.

Valentine, S.R. and T.L. Rittenburg. (2004). Spanish and American business professionals' ethical evaluations in global situations. *Journal of Business Ethics*, 51(1), 1-14.

Yigit Bora Senyigit . (2013). Auditor Independence: The Case of Arthur Andersen and Enron. *International Conference on Economic and Social Studies*, 10-11 May, Sarajevo. 275.

Zakaria, M., H. Haron and I. Ismail . (2010). Knowledge of ethics, perceived ethical problems and ethical judgments. *Journal of Financial Reporting and Accounting*, 8(1), 50-64.