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DOES AUDIT COMMITTEE MODERATE THE RELATIONSHIP BETWEEN AUDITOR INDEPENDENCE AND EARNINGS MANAGEMENT DURING INITIAL IMPLEMENTATION OF MFRS IN MALAYSIA?

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ABSTRACT

This paper presents an evaluation of auditor independence concerns against the backdrop of current Malaysian corporate financial scandals by examining the relationship between auditor independence and earnings management, and the role of audit committees in overseeing auditor independence. The study used 1,035 firm-year data in the main market of Bursa Malaysia from 2012 to 2014 and employed multivariate regression analyses. The results revealed that when non-audit fees and total fees were higher, it could reduce the auditor's independence as higher fees can create economic dependency on his clients. This study found that audit committee size and the frequency of meetings were positively related to earnings management. When testing the audit committee moderation on auditor independence, the study found that audit committee size and its frequency of meetings weaken the positive relationships between lower auditor independence and earnings management. These findings help regulators and professional bodies think about the impact of audit and NAS fees on auditor independence and the audit committee's oversight responsibility. To assess auditor independence, companies should form a fully independent audit committee in accordance with the Malaysian Code on Corporate Governance 2021 (Securities Commission of Malaysia, 2021).

Keywords: Auditor independence, audit committees, financial reporting quality, earnings management, external auditor, economic bonding.

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1. INTRODUCTION

The early 2000s in the United States (US) saw the exposure of several terminal accounting scandals like Enron, bringing auditor independence issues to the forefront. In Enron's case, it was revealed that Arthur Andersen charged $25 million of audit fees and $27 million of non-audit services (NAS), which had posed concerns about how an auditor balances its independence between the Enron's owners and business relationship wisth the organisation's management (Beattie & Fearnley, 2002). Meanwhile, in Malaysia, corporate financial scandals implicated 1Malaysia Development Bhd (1MDB), a government investment fund, which has made this phenomenon relevant to Malaysia. 1MDB is a Malaysian government landmark case involving embezzlement of over US$4.5 billion involving high-level officials and their acquaintances, which is currently a world renowned financial scandal that has dented Malaysia's reputation (Adam & Arnold, 2018). More recently, Serba Dinamik Holdings Bhd, an oil and gas business, was flagged by its former KPMG external auditor for questionable transactions exceeding RM4.54 billion, prompting the resignation of five of the company's seven independent directors (Barrock, 2021).

Besides the external auditor, there are other essential parts of corporate governance that also contribute towards the delivery of quality financial information, such as the audit committee. The audit committee is set up by the board of directors as required by Bursa Malaysia regulation to oversee the financial reporting matters like reviewing the external auditor's report and appointing an external auditor. Audit committees are, in effect, the gatekeepers of a corporation's financial integrity (Verschoor, 2008). The board of directors frequently allocates audit committees with broad responsibilities, which include reviewing financial matters and internal controls, and keeping communication flowing between the board, financial managers, external auditors, and internal auditors (Bavly, 1999).

To date, there are few studies specifically looking at the effect of audit committee interaction on the relationship between external auditor independence and financial reporting quality. A study by Sharma et al. (2011) found that audit committee moderated the relationship between client importance (NAS fees paid to sum of audit and non-audit fees of auditor office) and earnings management among the New Zealand public listed companies. In contrast, a research study on corporations included in S&P 1500 discovered that audit committee does not influence the relationship between the client importance (fee ratio, NAS fee and total fees) and earnings management (Bontje, 2015). Wu et al. (2016) also found that audit committee does not moderate the relationship between NAS fees and unmodified going-concern opinion, but mediates the relationship among troubled United Kingdom (UK) listed firms. A Malaysian study discovered that fully independent audit committee moderates the relationship between NAS and accruals quality (Nik Abdul Majid et al., 2021). Most of the studies on direct relationship between auditor committee and audit quality/financial reporting quality, and audit committee moderation on auditor independence and financial reporting quality/NAS are based on data prior to the implementation of new accounting standards, MFRS (Malaysian Financial Reporting Standards)/IFRS (International Financial Reporting Standards).

The objectives of the study are to examine the association between auditor fees and earnings management, and the interaction of audit-committee variables on the relationship between auditor fees and financial reporting quality during the initial implementation of MFRS.

The study extends current research in several ways. First, this study uses the data collected during the initial implementation of MFRS, where the data is based on the new accounting standards (MFRS/IFRS) and differs from previous studies conducted in the US, UK, New Zealand, and Malaysia. Sidik Jaafar and Abd Rahim (2012) suggests MFRS reporting would result in more fluctuations of the corporation's financial outcome due to the application of fair value accounting and can bring considerable effect on the statement of financial position and the profitability, which could provide different views on auditor independence. Although Sharma et al. (2011) and Bontje (2015) examined audit committee moderation on client important and earnings management (financial reporting quality), these studies use audit committee best practice and governance index as the proxy for audit committee. Instead of audit committee best practice and governance index, this study uses four main audit committee characteristics. We extend the work by Nik Abdul Majid et al. (2021) in examining the audit committee moderation on audit fees in the context of financial reporting quality. This will add to the literature on moderation of audit committee on auditor fees (auditor independence) and financial reporting quality, which are limited in Malaysia.

This paper will first provide a literature review of previous studies, followed by the development of hypotheses. The next section describes the research methodology, results, and discussion of findings before concluding the paper.

2. LITERATURE REVIEW

2.1. Auditor Independence

The issue of auditor independence and the delivery of audit quality has been widely discussed among regulators, legislators, and researchers. This issue is relevant to Malaysia as its auditing market charges low fees in an intensely competitive environment (Choong, 2012). This has resulted in an emphasis on economic bonding, which can possibly reduce auditor independence (Cassell et al., 2016). When auditor independence is impaired, it can affect the delivery of audit quality, which could potentially lower the financial reporting quality. Watts and Zimmerman (1983) suggest that the external auditor can decrease the manager's opportunistic prospects by reporting the manager's violations, and that the chance of being reported by the auditor is dependent on the interpretation of independence with reference to the auditing profession's practice. Academia also lists "principal factors that could influence auditor independence and they include: i] the economic dependence of the auditor on their client, ii] competition within the external audit market, and iii] the provision of NAS by the auditor" (Beattie et al., 1999, p. 71). Hoitash et al. (2007) who conducted their study in the US suggest that economic bonding (related to audit quality) between the auditors and their customers derives from both audit and non-audit fees.

2.2. The Role of Audit Committee and Auditor Independence

Under the Companies Act, the board has the duty to act in the best interests of the company and its shareholders. Furthermore, the Malaysian Code on Corporate Governance (MCCG), 2012 requires the board to provide credible financial statement information (Securities Commission of Malaysia, 2012). Hence, the board has the implicit role of providing quality financial information. As required by Bursa Malaysia, the board of directors must set up an audit committee for any company listed in the main market to oversee the financial reporting activities (Bursa Malaysia, 2020). The audit committee's role is to assist the board with some audit related duties, which includes appointing the independent auditor who oversees the auditing process and financial reporting matters (Menon & Deahl Williams, 1994). MCCG is under constant update and Table 1 below shows the summary development of the code on corporate governance from 2007 to 2021 as it pertains to the roles and requirements of the audit committee. The table below reveals that since MCCG 2007, it has promoted all the audit committee members to be comprised of independent directors and recommended that they meet more frequently (Securities Commission of Malaysia, 2007). The MCCG 2017 and 2021 recommends the audit committee to oversees the auditor independence and all the audit committee members should be financial literate (Securities Commission of Malaysia, 2017, 2021).

Table 1: Summary Development of MCCG Pertains the Audit Committees

MCCG	Revision theme	Main revision pertains to audit committee
2007	Putting in place the criteria for qualification of directors and strengthening the audit committee	• strives to strengthen the role of audit committees by requiring the committees to comprise fully of non-executive directors. • increases the frequency of meetings between the audit committee and the external auditor without the executive board members present.
2012	Strengthening board structure and composition recognising the role of directors as active and responsible fiduciaries	No update for the audit committee.
2017	To promote greater internalisation of corporate governance culture	• The audit committee should comprise solely of independent directors. • The audit committee has policies and procedures to assess the suitability, objectivity and independence of the external auditor. • All audit committee members should be financially literate and are able to understand matters under the purview of the Audit Committee including the financial reporting process.
2021	To ensure that it remains relevant and is aligned with globally recognised best practices and standards.	• The audit committee should comprise solely of independent directors. • The audit committee has policies and procedures to assess the suitability, objectivity and independence of the external auditor to safeguard the quality and reliability of audited financial statements. • All audit committee members should be financially literate and are able to understand matters under the purview of the audit committee including the financial reporting process.

Source: MCCG 2007, MCCG 2012, MCCG 2017 and MCCG 2021.

2.3. Agency Theory and Asymmetric Information on External Auditor and Audit Committee

Agency theory, as developed primarily by Jensen and Meckling (1976), is a relevant dogma in the current corporate governance scene (Kulik, 2005), like auditing and audit committee issues. Under the type 1 agency theory, auditing is needed as part of the accountability process by the manager to the owner. The agency theory highlights the existence of an agency problem where the manager might not act in the best interest of the owner (Sulong & Nor, 2008). An agency problem brings the asymmetry information between the manager and the owner, and therefore requires the role of an external auditor to narrow the information gap (Simunic, 1990). The process of auditing can moderate the management's earnings management activities and, hence, reduce the asymmetric information between the manager and the owner.

The agency setup highlights the role of the external auditor and the oversee role of the audit committees not only on the management internal control, but also on the external auditor. Since Bursa Malaysia has made it compulsory for the board of directors of all the firms listed on the main market to set up an audit committee to oversee the auditing process (including auditor independence) and financial reporting activities, agency theory suggests the audit committee functions as the moderator for auditor independence.

3. HYPOTHESES DEVELOPMENT

3.1. Auditor Independence and Earnings Management

It is established that earnings management can reduce the reliability of financial information (Zhou, 2008). External auditor characteristics under consideration include audit fees and non-audit fees. Non-audit fees received by the auditors indicate that there is a greater economic dependence on their clients. Ahmad et al. (2006) and Ianniello (2010) highlight that economic dependency on a client's fees can impair the auditor's independence. Similarly, Abdul Wahab et al. (2020) found that provisions of non-audit services create economic bonding and can pose a threat to auditor independence among Malaysian firms. The literature also highlighted that the traditional auditing market faced intense competition, which resulted in limited growth in price. Therefore, auditors are tapping into the consultancy sector to yield better margins.

Since previous Malaysian case studies like Ahmad et al. (2006), Bakar and Ahmad (2009) and Abdul Wahab et al. (2020) have shown consistent results of inverse associations between non-audit fees and the auditor's independence, this leads to the hypothesis that a lower level of auditor independence (represented by high economic bonding with higher audit fees, NAS fees and total fees – audit and non-audit fees) is related to higher earnings management.

H1: There is a negative relationship between auditor independence and earnings management.

3.2. The Audit Committee's Independence Moderates the Auditor's Independence

Most prior corporate governance studies have documented a positive relationship between independent directors and improved audit committee effectiveness. Studies conducted in the US and Malaysia indicated that the audit committee's independence was likely to i] have lower NAS fee ratios (Abbott et al., 2003a), and ii] demand for higher audit quality (Bliss et al., 2011). Furthermore, another study in Malaysia evidenced that the existence of a fully independent audit committee curbed earnings management activities (Saleh et al., 2007). Similarly, fully audit committee independence weakens the inverse relationship between NAS and accrual quality (Nik Abdul Majid et al., 2021). Based on the fact that the Malaysian Code of Corporate Governance 2017 recommends all audit committees be independent (Securities Commission of Malaysia, 2017) because its independence can promote objectivity in overseeing the financial reporting process and subsequently have higher expectations from the external auditor, the second hypothesis is as follows:

H2: The negative relationship between auditor independence and earnings management weakens when there are more independent directors in the audit committee.

3.3. The Audit Committee's Size Moderates the Auditor's Independence

Prior studies show that the audit committee size can affect the delivery of quality financial reporting. American audit committee size is limiting earnings management, which reveals more members on the audit committee allow better monitoring of financial reporting quality, possibly due to additional members' increasing their capability (Gul et al., 2011). On the same note, a Malaysian study found that audit committee size is one of the corporate governance mechanisms that can limit earnings management practice (Mansor et al., 2013). An Indonesian study conducted by Mardjono and Chen (2020) also discovered that audit committee size can curb earnings management activities. Collectively, a larger audit committee size has a lower cost of debt, earnings restatement, and earnings management. Therefore, this has led to the prediction that a bigger audit committee size can increase the capability of the committee, leading to the third hypothesis:

H3: The negative relationship between auditor independence and earnings management weakens when there are more audit committee members.

3.4. The Audit Committee's Frequency of Meeting Moderates the Auditor's Independence

Meetings among the audit committee members are mainly to execute their roles in protecting the best interests of the shareholders, such as reviewing the audit plan and internal control system with the external auditor. In contrast, the audit committees that meet less might have little time to review the complicated issues pertaining to financial reporting and the sufficiency of internal control.

Xie et al. (2003) found that the number of American audit committee meetings is related to a decrease in earnings management activities. A US study also found that audit committee independence is inversely associated with earnings management and has a stronger negative association when audit committees meet more frequently (Ebrahim, 2007). Similarly, another US study documents that the existence of an audit committee that meets at least biannually and comprises fully non-executive directors is linked to a reduced probability of fraud and unintentional misstatements (Abbott et al., 2000).

Based on these findings, it is predicted that the frequency of meetings contributes towards the audit committee's effectiveness and proper functioning to discharge its tasks, leading to the fourth hypothesis:

H4: The negative relationship between auditor independence and earnings management weakens when there are more audit committee meetings conducted.

3.5. The Audit Committee's Financial Expertise Moderates the Auditor's Independence

Bursa Malaysia, through its main market listing regulation, requires at least one member of the audit committee to be financially literate. This requirement is a contributing determinant of audit committee effectiveness, particularly in monitoring financial reporting quality. In addition, the Malaysian Code of Corporate Governance 2017 recommends that all members of the audit committee possess financial skills (Securities Commission of Malaysia, 2017).

Song and Windram's (2004) study on UK companies provides evidence that both directors with financial expertise and diligence could contribute towards audit committee effectiveness. A US study found that an audit committee that solely comprises independent directors and at least one who is financially literate is significantly and directly related to audit fees (representing a higher level of audit coverage) (Abbott et al., 2003b). On the same notion, Mardjono and Chen (2020) found audit committee financial expertise can reduce earnings management among Indonesian listed firms. Another study in Iran discovered audit committee's financial expertise significantly improve financial reporting quality (Safari Gerayli et al., 2021). These findings implies that effective audit committees are committed to demand for more extensive audits and improve financial reporting quality.

Financial literacy among the committee has been encouraged by the blue ribbon committee in the US and the Malaysian Code of Corporate Governance 2017, and also by Bursa Malaysia's listing requirement. These findings, coupled with encouragement by regulation, form the fifth hypothesis: that the stronger the audit committee's financial expertise, the more effective it is in overseeing the auditor's quality of work.

H5: The negative relationship between auditor independence and earnings management weakens when there are more audit committee members with financial expertise.

4. METHODOLOGY

4.1. Sample Selection

This study conducted quantitative research based on the population of the main market of public listed companies in Malaysia from 2012 to 2014, consisting of 1,035 firms' annual observations. The Malaysian Accounting Standards Board (MASB) has fixed Malaysian accounting standards to be fully convergent with IFRS starting from 1 January 2012, and it is applicable to all non-private corporations. This research study used total population sampling, which covered all the listed companies in the main market of Bursa Malaysia based on listed firms in 2014 except: i] banking, insurance, and finance industries; ii] companies with qualified audit opinions because these are perceived as qualified annual reports; iii] any industry with fewer than 10 companies in a particular sample year as required by the earnings management accrual model (Peasnell et al., 2000); iv] incomplete/unavailable firms' data; and v] agriculture and construction industries because these industries are entities allowed by MASB to defer full adoption of MFRS until the accounting period commencing 1 January 2017 (Malaysian Accounting Standard Board, 2014) to avoid any mixture of data in compliance and non-compliance of MFRS in their financial statements. The sample selection is depicted in Table 2.

Table 2: Sample Selection

Listed firms in 2014	799
Banking, insurance and finance firms	(34)
Firms deffered adoption of MFRS (including agriculture and construction industries)	(237)
Firms with qualified opinion	(23)
Industries with fewer than 10 firms	(14)
Incomplete/unavailable firms' data	(146)
Final sample firms	345
Total firm-annual observations for 2012 to 2014	1,035

4.2. Variable Measurements

Table 3 depicts the operational definitions of dependent, independent, control, and corporate governance variables.

Table 3: Operational Definitions of Variables

#	Variables	Definitions	Source(s)
1	EM – earnings management (dependent variable)	DAKasznik – (Kasznik, 1999)	DataStream
2	AIND – auditor independence (independent variables)	i] AF (audit fees) - the natural logarithm of the audit fee (Kanagaretnam et al., 2010); or ii] NAFR (non-audit fees) – the ratio of non-audit fees to total fees (Kanagaretnam et al., 2010; Nik Abdul Majid et al., 2021); or	Annual report

		iii] ATF (auditor total fees) - the natural logarithm of total fees - sum of audit and non-audit fees (Kanagaretnam et al., 2010)	
Control variables			
3	FSIZE (firm size)	The natural logarithm of total assets (Masmoudi, 2021)	DataStream
4	FRISK (firm risk)	Total liabilities divided by total assets (Setiawan et al., 2020)	DataStream
5	EASIZE (external auditor size)	Dummy variable, 1 = big 4, and 0 otherwise (Johl et al., 2012; Setiawan et al., 2020)	Annual report
Corporate governance variables			
6	ACIND (audit committee independence)	The proportion of independent committee members to total audit committee members (Johl et al., 2012; Setiawan et al., 2020)	Annual report
7	ACFE (audit committee financial expertise)	The proportion of committee members with accounting and finance expertise to total audit committee members (Johl et al., 2012; Setiawan et al., 2020)	Annual report
8	ACSIZE (audit committee size)	Total number of audit committee members (Setiawan et al., 2020)	Annual report
9	ACFM (audit committee frequency of meetings)	The number of AC meetings held during the year (Johl et al., 2012; Setiawan et al., 2020)	Annual report

Notes: Data from annual reports are hand collected. Annual reports are downloaded from Bursa Malaysia's website.

This study is considering two alternative discretionary accrual models, Kasznik (1999) and Modified Jones (Dechow et al., 1995) to estimate earnings management, and the model with the highest explanatory power [R^2] will be chosen to analyse the research models following the method used by Siregar and Utama (2008).

4.3. Evaluation of Data and Analysis Model

This study employed Wooldridge and Modified Wald Statistics tests to detect the data autocorrelation and heteroskedasticity, respectively, and tests for the presence of time series and cross-sectional dependencies were conducted for time effect and fixed firm effect, respectively. The Poolability F-test, Breusch-Pagan Lagrange Multiplier, and Hausman tests are conducted to determine whether pooled ordinary least squares [POLS], fixed effect model or random effect model is the most appropriate approach to analyse the data.

4.4. Model Specification

This study used the random effect model to investigate the relationship between auditor independence and earnings management and the moderation of the audit committee on the relationship between auditor independence and earnings management (see Section 5.2, Selection Earnings Management Model, Data Tests and Selection of Estimated Model below). The following models are run with the "robust cluster(firm) with time dummies" command when the independent variable is AF, and the "robust cluster with time dummies" command when the independent variables are NAFR and ATF, to address the problems of autocorrelation, heteroscedasticity, firm fixed effect, and time effect in the data. To test H1, the study used Model 1 under equation 1:

$$|EM| = \beta_0 + \beta_1 AINDit + \beta_2 FSIZE_{it} + \beta_3 FRISK_{it} + \beta_4 EASIZE_{it} + \beta_5 ACCHA_{it} + \eta_i + \mu_{it} \quad \text{[Equation 1]}$$

Model 2 was used to test H2 to H5's predictions that the audit committee moderates the association between auditor independence and earnings management under equation 2:

$$|EM| = \beta_0 + \beta_1 AIND_{it} + \beta_2 FSIZE_{it} + \beta_3 FRISK_{it} + \beta_4 EASIZE_{it} + \beta_5 ACCHA_{it} + \beta_6 ACCHA_{it}{*}AIND_{it} + \eta_i + \mu_{it} \quad \text{[Equation 2]}$$

Where:

$|EM|$ = absolute value of earnings management

$ACCHA_{it}$ = audit committee (AC) characteristics - ACIND, ACSIZE, ACFM and ACFE

Notes: All other variables are defined in Table 3.

5. RESULTS AND DISCUSSION

5.1. Descriptive Statistics and Correlation Matrix

Table 4 depicts the descriptive statistics for the variables employed in this study. The results showed that the mean value of audit fees was RM337,654 and ranged from RM8,000 to RM12,400,000, indicating that the mean for audit fees was higher than the mean of RM240,856 reported by Johl et al. (2012). The non-audit fees to total fees ratio had the minimum and maximum values of 0 and 0.938 respectively, with an average value of 0.184. The ratio value of 0.184 reflected the lower fees incurred by Malaysian firms in comparison with audit fees.

The audit committee's independence and its accounting/finance expertise mean ratios were 0.896 and 0.387, respectively. The mean ratio for audit committee independence was approximate to Bamahros and Wan-Hussin's (2015) ratio of 0.870 but the audit committees with accounting/finance expertise ratio was lower than Johl et al.'s (2012) result of 0.591. The audit committee had an average (median) size of 3.269 (3) members within the range of 3 to 6 members. The average for audit committee size was comparable to Bamahros and Wan-Hussin's (2015) study with an average of 3.25 members. The audit committee conducted an average (median) of 4.874 (5) meetings, ranging from 2 to 15 meetings. The average and median values for both variables, audit committee size and meetings conducted were notably close to each other.

Table 4 shows that the average earnings management using Kasznik's (1999) model was 0.001 as its minimum and maximum values were -0.497 and 1.277, respectively, with a standard deviation of 0.101.

Table 4: Descriptive Statistics

Panel A					
Variable	**Mean**	**Min**	**Max**	**Median**	**Std Dev**
Independent variables					
NAFR	0.184	0.003	0.938	0.150	0.159
AF (RM)	337,654	8,000	12,400,000	156,100	754,168
ATF (RM)	450,429	8,000	20,300,000	185,000	1,174,524
Control variables					
FSIZE (RM'000)	1,493,798	20,573	111,000,000	264,127	6,920,122
FRISK	0.358	0.009	0.884	0.354	0.177
EASIZE	0.523	0	1	1	0.500
Corporate governance variables					
ACIND	0.896	0.500	1	1	0.149
ACFE	0.387	0	1	0.333	0.155
ACSIZE	3.269	3	6	3	0.561
ACFM	4.874	2	15	5	1.085
Dependent variables					
DAMJones	-0.002	-0.412	1.167	-0.004	0.093
DAKasznik	0.001	-0.497	1.277	-0.003	0.101

Panel B			
Variable	**Dummy = 1**	**Dummy = 0**	**Total**
EASIZE no. of observations (%)	541 (52.27)	494 (47.73)	1,035 (100)

Notes: Please refer to Table 3 for operational definitions.

The results of correlations amongst the independent, control, and moderating variables are relatively low. All values are well below 0.80, except for the correlation between audit fees and total fees (0.9450), and discretionary accruals under Modified Jones and Kasnik models (0.8115). However, Gujarati and Porter (2009) suggested a correlation between two variables exceeding 0.80 could post a serious concern. In this case, Gujarati and Porter (2009)'s guideline of 0.80 is not relevant for correlation between audit fees and total fees due to the total fee measurement comprised of both audit and non-audit fees, which gives rise to high correlation between audit fees and total fees as both measurements contained audit fees element. On the same notion, both Modified Jones and Kasnik models are measuring similar items, discretionary accruals which give rise to high correlations between them.

5.2. Selection Earnings Management Model, Data Tests and Selection of Estimated Model

This section makes a comparison between the two earnings management methods, modified Jones (Dechow et al., 1995) and Kasznik (1999).

Table 5: R^2 Of Earnings Management Models

Year	2012/13	2013/14	Average
DAKasznik	6.35%	6.23%	6.29%
DAMJones	4.90%	5.82%	5.36%

Table 5 shows that the average R^2 for DAKasznik and DAMJones are 6.29% and 5.36%, respectively, hence DAKasznik has higher R^2 and is the best model for earnings management measurement.

The results of Wooldridge and Modified Wald Statistics tests indicate that the data set has both autocorrelation and heteroscekasticity problems. Further fixed effect model and time dummies tests show that the data has a firm fixed effect and a time effect when AF is used as an independent variable, and the data has a time effect when NAFR and ATF are used as independent variables. Hence, the "robust cluster(firm) with time dummies" command is applied when running the AF analyses to address the autocorrelation, heteroscekasticity, firm fixed effect, and time effect situations. The "robust with time dummies" command is used to run the NAFR and ATF analyses to address the autocorrelation, heteroscekasticity, and time effect situations.

Poolability F-test on a fixed effect model and Hausman tests cannot be conducted due to "robust" command in running the tests. Hence, one test, Breush Pagan LM has been conducted, and the result shows that the random effect model is preferred over POLS.

5.3. Regression Results

A total of 15 regressions were carried out, as reported in Tables 6 to 7d. The first three regressions examined the relationship between auditor independence and earnings management, using three different auditor independence measurements to test the first hypothesis, H1. The fourth to fifteenth regressions examined the audit committee moderation on audit fees, non-audit fees to total fees ratio, and total fees (auditor independence) relationships, with earnings management to test H2 to H5.

Table 6: Results of Auditor Independence and Earnings Management

Regression	1	2	3
AF	0.0036		
	(0.0036)		
NAFR		0.0498*	
		(0.0262)	
ATF			0.0135***
			(0.0051)
EASIZE	-0.0018	-0.0041	-0.0059
	(0.0053)	(0.0063)	(0.0065)
FSIZE	-0.0108***	-0.0091***	-0.0157***
	(0.0025)	(0.0022)	(0.0036)
FRISK	0.0251	0.0290	0.0265
	(0.0189)	(0.0235)	(0.0234)
ACSIZE	0.0030	0.0002	0.0020
	(0.0035)	(0.0041)	(0.0037)
ACFE	-0.0217*	-0.0243	-0.0222
	(0.0122)	(0.0151)	(0.0141)
ACIND	0.0015	0.0147	0.0142
	(0.0158)	(0.0165)	(0.0166)
ACFM	0.00213	0.0025	0.0022

	(0.0018)	(0.0020)	(0.0020)
tdum2	-0.0266***	-0.0273***	-0.0283***
	(0.0051)	(0.0062)	(0.0063)
tdum3	-0.0142**	-0.0133*	-0.0147*
	(0.0062)	(0.0077)	(0.0078)
Constant	0.1450***	0.1530***	0.0771**
	(0.0362)	(0.0324)	(0.0329)
Observations	1,035	791	791
R-squared	0.0515	0.0592	0.0588

Notes: ***, **, * statistically significant at the <1%, <5%, <10% levels respectively; robust standard errors in parentheses; time dummy (tdum). All other variables are defined in Table 3.

When AF, NAFR, and AFT are higher, the auditor's independence is lower. Table 6 provide the results for the relationship between audit independence (measured by AF, NAFR and AFT) and earnings management. In line with H1, it shows there is correlation between auditor independence and earnings management. The results show weaker auditor independence (proxied by higher NAFR and AFT) have positive coefficiency with earnings management. This provides some evidence to suggest that joint provision of NAS and audit services could impair the auditor independence, which is consistent with the economic bonding prediction (Ahmad et al., 2006; Ianniello, 2010). Likewise, this finding concur with Bamahros and Wan-Hussin's (2015) results that higher non-audit fees were associated with increase in values of discretionary current and total accruals, and Nik Abdul Majid et al.'s (2021) found that NAS is positively related to absolute value of estimation error.

Tables 7a and 7d tabulate the results for the audit committee characteristics. We found there are negative relationships between ACFE and earnings management. The significant results concur with Mardjono and Chen (2020) and Safari Gerayli et al. (2021) studies where they discovered ACFE improves financial reporting quality. On the other hand, the results reveal that ACFM and ACSIZE are positively related with earnings management. The positive significant ACFM result is supported by Setiawan et al. (2020), where ACFM is associated with an increase in earnings management. This finding suggests that the audit committee is new to principle-based MFRS, ACFM and ACSIZE could not effectively monitor the earnings management at an early stage of MFRS implementation. There is insufficient evidence to prove the relationship between ACIND, audit firm size and firm risk with earnings management. Insignificant results for ACIND contradict Saleh et al.'s (2007) results, and audit firm size and firm risk results (control variables) are not in line with Setiawan et al.'s (2020) findings. The insignificant results between ACIND and earnings management suggest that firms need a fully independent audit committee to improve their effectiveness. Audit firm size do not mitigate earnings management and firm risk do not promote earnings management activities. The R^2 values of this study, ranging from 5.15% to 6.33% should not pose any concern as there are previous studies within the accounting/finance having low R^2. A research conducted in the US had the R^2 ranging from 2% to 7.17% (Larcker et al., 2007), while a Malaysian study conducted by Cheong et al. (2015) had the R^2 ranging from 0.1% to 23.9%. Further, Larcker et al. (2007) suggested that establishing the minimum level of R^2 for compliance in each study before substantiating a conclusion was challenging as this reference point was highly dependent on the nature and context of the study.

Table 7a: Results with Interactive Effect of Audit Committee Independence and Auditor Independence on Earnings Management

Regression	4	5	6
AF	0.0160		
	(0.0144)		
NAFR		0.0882	
		(0.1381)	
ATF			0.0268**
			(0.0125)
AF*ACIND	-0.0140		
	(0.0151)		
NAFR*ACIND		-0.0430	
		(0.1530)	
ATF*ACIND			-0.0153
			(0.0129)
EASIZE	-0.0017	-0.0040	-0.0057
	(0.0053)	(0.0064)	(0.0064)
FSIZE	-0.0108***	-0.0091***	-0.0155***
	(0.0026)	(0.0022)	(0.0036)
FRISK	0.0248	0.0290	0.0260
	(0.0189)	(0.0235)	(0.0235)
ACSIZE	0.0029	0.00024	0.0019
	(0.0035)	(0.0041)	(0.0038)
ACFE	-0.0216*	-0.0238	-0.0217
	(0.0122)	(0.0151)	(0.0141)
ACIND	0.1710	0.0223	0.2040
	(0.1880)	(0.0238)	(0.1600)
ACFM	0.0021	0.0025	0.0022
	(0.0018)	(0.0020)	(0.0020)
tdum2	-0.0268***	-0.0274***	-0.0284***
	(0.0051)	(0.0062)	(0.0063)
tdum3	-0.0144**	-0.0135*	-0.0149*
	(0.0063)	(0.0074)	(0.0078)
Constant	-0.0056	0.1470***	-0.0902
	(0.1760)	(0.0338)	(0.1440)
Observations	1,035	791	791
R-squared	0.0523	0.0592	0.0598

Notes: ***, **, * statistically significant at the <1%, <5%, <10% levels respectively; robust standard errors in parentheses; Time dummy (tdum). All other variables are defined in Table 3.

Table 7b: Results with Interactive Effect of Audit Committee Frequency of Meetings and Auditor Independence on Earnings Management

Regression	**7**	**8**	**9**
AF	0.0124		
	(0.0079)		
NAFR		0.1580***	
		(0.0584)	
ATF			0. 0264***
			(0.0085)
AF*ACFM	-0.0018		
	(0.0015)		
NAFR*ACFM		-0.0212**	
		(0.0096)	
ATF*ACFM			-0.0026*
			(0.0014)
EASIZE	-0.0018	-0.0046	-0.0058
	(0.0053)	(0.0062)	(0.0065)
FSIZE	-0.0105***	-0.0087***	-0.0152***
	(0.0026)	(0.0022)	(0.0036)
FRISK	0.0243	0.0293	0.0256
	(0.0190)	(0.0232)	(0.0234)
ACSIZE	0.0032	0.0007	0.00217
	(0.0036)	(0.0040)	(0.0038)
ACFE	-0.0218*	-0.0266*	-0.0228
	(0.0122)	(0.0154)	(0.0143)
ACIND	0.0008	0.0137	0.0139
	(0.0158)	(0.0164)	(0.0166)
ACFM	0.0257	0.0074**	0.0371*
	(0.0201)	(0.0034)	(0.0204)
tdum2	-0.0266***	-0.0273***	-0.0282***
	(0.0051)	(0.0062)	(0.0063)
tdum3	-0.0140**	-0.0131*	-0.0145*
	(0.0062)	(0.0077)	(0.0078)
Constant	0.0274	0.1240***	-0.1000
	(0.1070)	(0.0349)	(0.1060)
Observations	1,035	791	791
R-squared	0.0522	0.0629	0.0615

Notes: ***, **, * statistically significant at the <1%, <5%, <10% levels respectively; robust standard errors in parentheses; Time dummy (tdum). All other variables are defined in Table 3.

Table 7c: Results with Interactive Effect of Audit Committee Size and Auditor Independence on Earnings Management

Regression	**10**	**11**	**12**
AF	-0.0029		
	(0.0113)		
NAFR		0.2020**	
		(0.0998)	
ATF			0.0096
			(0.0111)
AF*ACSIZE	0.0020		
	(0.0034)		
NAFR*ACSIZE		-0.0448*	
		(0.0242)	
ATF*ACSIZE			0.0012
			(0.0029)
EASIZE	-0.0018	-0.0053	-0.0058
	(0.0053)	(0.0064)	(0.0065)
FSIZE	-0.0110***	-0.0087***	-0.0158***
	(0.0026)	(0.0022)	(0.0036)
FRISK	0.0251	0.0274	0.0265
	(0.0189)	(0.0236)	(0.0235)
ACSIZE	-0.0214	0.0107*	-0.0127
	(0.0421)	(0.0060)	(0.0365)
ACFE	-0.0219*	-0.0239	-0.0224
	(0.0122)	(0.0150)	(0.0141)
ACIND	0.0015	0.0151	0.0142
	(0.0158)	(0.0165)	(0.0166)
ACFM	0.0021	0.0028	0.0022
	(0.0018)	(0.0020)	(0.0020)
tdum2	-0.0266***	-0.0271***	-0.0283***
	(0.0051)	(0.0061)	(0.0063)
tdum3	-0.0142**	-0.0131*	-0.0147*
	(0.0062)	(0.0076)	(0.0078)
Constant	0.2280	0.1130***	0.1280
	(0.1490)	(0.0323)	(0.1330)
Observations	1,035	791	791
R-squared	0.0518	0.0633	0.0589

Notes: ***, **, * statistically significant at the <1%, <5%, <10% levels respectively; robust standard errors in parentheses; Time dummy (tdum). All other variables are defined in Table 3.

Table 7d: Results with Interactive Effect of Audit Committee Financial Expertise and Auditor Independence on Earnings Management

Regression	**13**	**14**	**15**
AF	-0.0032		
	(0.0063)		
NAFR		0.0541	
		(0.0532)	
ATF			0.0082
			(0.0077)
AF*ACFE	0.0170		
	(0.0136)		
NAFR*ACFE		-0.0098	
		(0.0849)	
ATF*ACFE			0.0132
			(0.0139)
EASIZE	-0.0017	-0.0041	-0.0058
	(0.0053)	(0.0063)	(0.0065)
FSIZE	-0.0107***	-0.0091***	-0.0156***
	(0.0025)	(0.0022)	(0.0036)
FRISK	0.0253	0.0290	0.0265
	(0.0189)	(0.0236)	(0.0234)
ACSIZE	0.0029	0.0002	0.0019
	(0.0035)	(0.0041)	(0.0037)
ACFE	-0.2290	-0.0221	-0.1880
	(0.168)	(0.0195)	(0.1760)
ACIND	0.00134	0.0147	0.0139
	(0.01580)	(0.0165)	(0.0166)
ACFM	0.0022	0.0025	0.0024
	(0.0018)	(0.0020)	(0.0020)
tdum2	-0.0266***	-0.0273***	-0.0282***
	(0.0051)	(0.0062)	(0.0063)
tdum3	-0.0141**	-0.0134*	-0.0145*
	(0.0062)	(0.0077)	(0.0078)
Constant	0.2250***	0.1520***	0.1420**
	(0.0743)	(0.0313)	(0.0725)
Observations	1,035	791	791
R-squared	0.0523	0.0592	0.0593

Notes: ***, **, * statistically significant at the <1%, <5%, <10% levels respectively; robust standard errors in parentheses; Time dummy (tdum). All other variables are defined in Table 3.

Tables 7a to 7d present the moderating effect of the audit committee on the relationship between auditor independence and earnings management. Four audit committee variables are being tested, which include audit committee independent (ACIND), audit committee meeting (ACFM), audit committee size (ACSIZE) and audit committee financial expertise (ACFE). The regression for interaction is run separately for each audit committee variable. Regressions 4 to 15 in tables 7a to 7d provide a moderating effect for each audit committee variable on the relationship between auditor independence and earnings management. Consistent with H3 and H4, the results reveal negative relationships between the interaction terms of ACFM and ACSIZE, and auditor independence with earnings management. The significant negative coefficients on interaction imply that ACFM and ACSIZE reduce the direct relationship between lower auditor independence and earnings management. These results are not in line with Nik Abdul Majid et al.'s (2021) findings, where there is insufficient evidence to prove the moderation effect of ACFM and ACSIZE on the relationship between NAS and accruals quality. These findings are supported by Sharma et al. (2011), audit committee moderated the association between client importance and earnings management. The rest of the audit committee variables (ACIND and ACFE) provide no moderation effect in supporting H2 and H5. The audit committee independence has a mean of 0.896, which is yet to have a fully independent audit committee, might not effectively oversee the auditor independence.

6. CONCLUSION

This study investigates the association between auditor independence and financial reporting quality, and the role of the audit committee in monitoring auditor independence. The results of this study show that external auditors providing either solely NAS (Bamahros & Wan-Hussin, 2015; Abdul Wahab et al., 2020) or joint provision of both NAS and auditing services (Haji-Abdullah et al., 2017) could impair their independence as higher fees can create economic dependence on their clients. The interaction of audit committee frequency of meetings and size prove moderating the relationships between auditor independence and earnings management. The firms should get a fully independent audit committee as requisite by the Malaysian Code on Corporate Governance 2021 (Securities Commission of Malaysia, 2021) to examine auditor independence.

The results of this study bring a few new perspectives to regulators and professional bodies. Firstly, there is an auditor independence impairment when NAS fees or total [audit and non-audit] fees are higher. This implies that higher fees received by the auditor from his clients could create economic bonding between them and, subsequently, pose a threat to auditor independence. Currently, the MIA by-law requires total fees derived from the client and its related entities among listed companies to represent more than 15% of total firm income to have an external review for independence threat (Malaysian Institute of Accountants, 2018). It is recommended that MIA look into the introduction of certain restrictions on the level of non-audit services, which an auditor can provide to his clients or client group of companies to reduce the economic dependency by auditors on their clients. Additionally, MIA should consider reducing the 15% threshold to a lower percentage. Secondly, the audit committee should setup policies governing the NAS and audit services engagement to ensure the external auditors do not reach the economic dependence threshold.

Agency theory suggests external auditors and audit committees can reduce the asymmetric information between the manager and the owner. Hence, the external auditor's independence is important in reducing this information gap. The results of this study show that both audit and non-audit fees can create economic bonding between an external auditor and its clients. Consequently, the level of fees is vital in ensuring the auditor monitoring value is not diminished, and continuous audit committees in reviewing the external auditor's economic dependency can safeguard auditor independence with reference to the firm's engagement rules and policies.

One possible avenue for future research is to study audit independence issues using auditing hours, as the fees can be affected by many factors. This research found that the audit committee's independence and financial literacy did not moderate the external auditor's independence and, thus, future research can explore audit committee members' involvement in other sub-committees such as remuneration and nomination. This is because their extensive involvement in other sub-committees might divert their focus from their roles as audit committee.

There are numerous limitations that need to be considered before interpreting the results of this study. The sample populations were derived from companies that are listed on Bursa Malaysia's main market. Therefore, generalising the findings of this study to non-Bursa Malaysia's main market and its implications may need to be considered.

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