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Auditor Relational Strategy and Risk of Fraudulent Financial Statements

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ABSTRACT

This study examines how auditor relational strategy influences the risks of fraudulent financial statements. The study uses panel data regression on 2,890 year-observations of companies listed in Bursa Malaysia during the period 2013-2017 to evaluate possible relationships between auditor relational strategy and risks of fraudulent financial statements. The results reveal that utilising an auditor relational strategy adds value by assisting auditors in reducing the risks of fraudulent financial statements. This suggests auditors can maintain their scepticism despite close client relationships. The findings propose that even when auditor-client relationships are close, the risk of fraudulent financial statements can be diminished as long as auditors can uphold their independence in auditor relational strategy. Therefore, to ensure that scepticism remains a relevant and consistent practice among auditors, policymakers may need to consider updating the rules and regulations to ensure that auditors provide services with professional conduct. This study makes a valuable contribution to the literature by examining the importance of auditor relational strategy in assisting auditors in minimising risks of fraudulent financial statements from a network theory perspective to ensure that auditors provide services with professional conduct.

Keywords: Auditor-client relationship; auditor relational strategies; fraud; risk; network theory

INTRODUCTION

We investigate the impacts of an auditor's relational strategy on the risk of fraudulent financial statements. Notably, fraudulent financial statements significantly impact corporate trust, credibility, and quality of financial reporting. As such, the Association of Certified Fraud Examiners (ACFE 2020) noted that although financial statement fraud has a low 10% incidence rate among fraud types, its repercussions are severe, eroding trust and integrity in the business world. This leads to financial losses and market uncertainties, increasing the potential for extreme financial harm and organisational collapse (ACFE 2014; PwC 2020; Smaili et al. 2022). In particular, Malaysia has seen a surge in fraud in financial statements. ACFE's Asia Pacific Edition Report disclosed 14 fraud cases investigated in Malaysia in 2018, which ranked prominently in ACFE's scrutiny alongside Indonesia and Singapore. Additionally, the Securities Commission of Malaysia (SC) reported that RM11.4 million was associated with corporate misconduct and accounting standard violations in 2019. These incidents significantly impact corporate reputation and investment climate, echoing global trends where financial statement fraud has caused massive investor losses and tarnished countries' images (Cheng et al. 2021). Therefore, identifying and mitigating the risk of fraudulent financial statements is crucial for stakeholder interests (Shen et al. 2021), which requires the external auditors to fulfil their responsibility in auditing the financial statements effectively.

Nevertheless, the fact remains that the audit work did not detect many fraud cases that happened globally. Instead, they were uncovered by other parties or discovered accidentally. Many fraud cases globally are discovered by accident, where 3.9% of fraud cases are reported by companies with whistle-blower hotlines and 7.8% by companies that do not have hotlines (ACFE 2016). This implies that internal and external auditing may be inadequate and fail to undertake a fraud risk assessment, accounting irregularities, and ineffective external audits (Baatwah 2016; Bahrawe et al. 2016). Additionally, a close auditor-client relationship due to a long and consecutive period of client reappointment was criticised for influencing the auditors' ability to withstand independence and not fully sceptical toward frauds or potential frauds. Instead of enhancing auditors' knowledge and experience with clients, many past studies have debated that a long tenure of auditor-client engagement may increase an auditor's economic dependence on the client. This, in turn, could jeopardise the auditor's scepticism and independent judgment.

The collaboration between auditors and clients is essential as the auditors heavily depend on clients for crucial company information during audits. Clients usually have a more profound knowledge of their companies than auditors, often leading to biased information favouring the client. Notably, this information imbalance has long been acknowledged as a significant concern in auditor-client relationships (Ruyter & Wetzel 1999). However, aside from client cooperation, it is essential to maintain a professional distance between auditors and clients to uphold auditor independence. Thus, we are concerned that auditor-client interaction greatly impacts audit effectiveness and the accuracy of financial statement reports. Moreover, how well auditors manage this

interaction often determines the willingness of clients to share corporate information. Fontaine (2011) identified two key strategies, i.e., relational and transactional. Other than that, relational strategy benefits auditors seeking additional valuable services (Fontaine 2011), offering clients timely audit reports (Butcher et al. 2011), easy access to auditors, and improved accounting practices (Fontaine & Pilotti 2016; Butcher et al. 2011). In addition, relational strategies may offer opportunities for collaboration; however, they may also carry risks. Meanwhile, excessive closeness might enable clients to hide financial manipulations, undermining auditor scepticism and increasing fraud risk (Mahami & Mouloudj 2020). The transactional strategy, preferred by auditors, is focused solely on audit services, minimises collaboration, and preserves scepticism (Fontaine 2011). Furthermore, a transactional strategy preserves auditor scepticism and mitigates fraud risk (Fontaine 2011). However, the absence of close interdependence of collaboration can make clients hesitant to share company information, hindering auditors from acquiring complete data and increasing the risk of fraud (Gronroos 2000; Fontaine 2011). Both strategies have trade-offs in balancing collaboration and fraud risk, influencing audit effectiveness.

We argue that the auditor's interaction strategies with a client may discipline the auditors while conducting the audit work (Fontaine 2011; Fontaine & Pilotti 2016). Previous studies have highlighted the importance of auditors remaining sceptical in interacting with their clients. Despite that, the extent to which auditor interaction strategy is able to influence the risk of fraudulent financial statements has never been assessed, mainly when the auditors prefer a relational strategy. Thus, it is crucial to determine how auditors can effectively leverage auditor relational strategy to enhance their capacity to minimise fraudulent financial statements without compromising their professional scepticism. Inspired by Fontaine and Pilote (2012), who argued that auditor relational strategy might lead auditors to lose their scepticism, we set out an objective to ascertain that the impact does not disrupt the quality of financial statements and offers a path for rectification. Additionally, we argue that the Malaysian setting can highlight the network's role among auditors and clients in monitoring the risk of fraudulent financial statements. Similarly, Rahmat et al. (2021) asserted that auditors with a close relationship due to long tenure of appointment are able to withstand independence and minimise the risk of undisclosed related party transactions. This finding motivates us to examine the association in the context of Malaysian listed companies to observe whether the auditor's approach to utilising the relational strategy can effectively minimise fraud risk in financial statements. It may imply countering Fontaine's (2011) and Fontaine and Pilotti's (2016) argument that the relational approach may trap auditors to compromise their independence.

The dataset comprises 578 companies listed on Bursa Malaysia from 2013 to 2017, totalling 2,890 year-observations. We utilise a panel data fixed effect model to analyse the relationships, and the findings indicate a negative relationship between auditor relational strategy and the risk of fraudulent financial statements. This inverse relationship can be attributed to the fact that over an extended period, auditor relational strategy contributes positively to forming a close relationship between auditors and clients. Consequently, clients become more willing to disclose corporate information, serving as a deterrent against the risk of fraudulent financial statements. Overall, auditors with a relational strategy do not inherently compromise their independence. This contradicts Fontaine and Pilote's (2012) concern that choosing a relational strategy may cause auditors to be trapped in economic dependence conflict. Instead, the findings align with those of Rahmat et al. (2021) and Rahmat and Ali (2016), who stated that the relational approach contributes to the auditor's improved familiarity with and understanding of the client's company.

This study significantly contributes to existing literature, extending previous research by Fontaine and Pilotti (2016) and Rahmat et al. (2021) in several ways. Firstly, this study provides a better understanding of the network relationship between auditors and clients by applying the auditor relational strategy, contributing new knowledge in auditing and the risk of fraudulent financial statements. Thus, we present fresh evidence suggesting that auditor relational strategy can potentially mitigate the risk of fraudulent financial statements. This study embeds an effect of the network that has become established over time between auditor and client that could endeavour to explore the equilibrium between scepticism and cooperation since auditors rely on complete information from the clients. In particular, the auditor relational strategy introduces an additional network that can exist among the controlling owner (principal), agent, and auditor. The concept of auditor-client strategy becomes a valuable tool in the context of networks that are established among these three parties. Accordingly, our findings demonstrate that auditor relational strategy encourages clients to voluntarily share their corporate information, reducing the risk of fraudulent financial statements. Thus, this study expands the literature on auditor interaction strategy by emphasising that the auditor relational strategy may not always represent a negative position. Instead, it helps auditors enhance their audit work by maintaining the integrity of financial reporting.

The remaining sections are organised as follows: Section 2 discusses related theories, the literature review, and hypotheses development. Section 3 describes the research method, while Section 4 presents the empirical results. Finally, Section 5 discusses the findings and concludes the study.

LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

AGENCY THEORY AND NETWORK THEORY

Financial statement fraud has become a primary concern for various stakeholders, as it plays a pivotal role in assessing a company's performance. Notably, manipulating financial statements can lead investors to make erroneous investment decisions, resulting in substantial losses. The severe repercussions of financial statement fraud have prompted professionals to delve deeper into the motivations of those behind such. Several theories offer insights into the analysis methods used to identify the likelihood of the risk of fraudulent statements, with one of the most renowned being the agency theory. Agency theory underscores the crucial role that independent auditors play in monitoring and resolving conflicts between agents and principals. This theory perceives the three key parties in an agency relationship as distinct entities, highlighting the potential benefits of effective auditor oversight. In this context, managers, acting as agents, are often viewed as having motivations to pursue their self-interest, sometimes at the expense of shareholders, who assume the role of principal. Antle (1982) concluded that, in pursuit of self-interest, auditors and managers (clients) might engage in collaborations that result in the manipulation of financial statements. This perspective aligns with viewpoints put forth by DeAngelo (1981) and Jensen and Meckling (1976), who argued that when the principal's objectives align with the agent's, the agency relationship tends to be cooperative. However, this raises concerns about potential agency problems where the manager prioritises personal gain over the principal's interests, leading to conflicts of interest that could compromise the integrity of financial statements.

This study utilises a network perspective within the agency theory framework to describe how principal and external auditors collaborate to oversee stakeholders' agents. In these relationships, all parties seek mutual benefits (McCallum et al. 2014). Particularly in professional services, it is preferable to establish formal contracts to avoid emotional entanglements (Granovetter 1983). Furthermore, auditors are prohibited from using aggressive marketing tactics, causing clients to rely on personal connections or recommendations from friends when selecting auditors (Hope et al. 2012; Guan et al. 2016; Berglund & Eshleman 2019; Christensen et al. 2019). For instance, Beattie and Fearnley (1998) discovered that 74% of clients were acquainted with their auditors before the appointment. Subsequently, auditors often develop interpersonal relationships with clients over time due to regular communication (Meyer et al. 2007; Ball et al. 2015). According to network theory, a contractual relationship only forms when it benefits both parties (Gibson et al. 2014; McCallum et al. 2014). From the client's perspective, selecting and reappointing an auditor depends on the value derived from audit reports (Aslan & Aslanertik 2017; Quick & Schmidt 2018). This implies that the appointed auditor is expected to bring value to the client. Conversely, audit firms primarily benefit from audit fees, which constitute their main source of income (Goldman & Berlev 1974; Nichols & Price 1976). However, ethical principles constrain auditors from issuing reports that merely align with client expectations, even in cases where prior consultations have occurred. Consequently, clients' expected benefits are not guaranteed.

AUDITOR RELATIONAL STRATEGY AND THE RISK OF FRAUDULENT FINANCIAL STATEMENTS

A deeper understanding of auditor relational strategy is vital, as it guides auditors' interactions with clients during audits (Antle & Nalebuff 1991). Auditor relational strategy describes auditors' approach to managing their professional client relationships. It focuses on how auditors balance maintaining professional independence with fostering a cooperative relationship to ensure auditors remain objective while effectively engaging with clients (Fontaine 2011). Note that this strategy is an ongoing process that promotes interdependence between auditor and client (Dwyer et al. 1987; Morgan & Hunt 1994). As such, cooperation is vital for building long-term relationships, contributing to the success of auditor-client relationships. However, the drawbacks are that a close auditor-client relationship may develop over time, and auditors' increasing dependence on clients can reduce scepticism and heighten fraud risk. This allows opportunist clients to conceal manipulations in company transactions.

The risk of fraudulent financial statements is defined as the probability that a company's financial statements are deliberately manipulated to present a false view of its financial position. The most common forms of financial statement fraud include the overstatement of revenues, understatement of liabilities, and inappropriate valuation of assets. Fraudulent risk increases when the systems designed to detect and prevent misreporting, including external audits, fail to operate effectively (Kassem 2023). In addition, a close auditor-client relationship can weaken the effectiveness of these systems, as familiarity may reduce auditors' critical assessment of the company's financial practices, leading to reduced scepticism and, consequently, an elevated risk of fraud (Tepalagul & Lin 2015). Compared to a transactional strategy that operates on an "arm-length" approach and does not rely on auditor-client interdependence, it is a distinct and short-term relationship that ends once a task is completed, emphasising competition and self-interest rather than nurturing client relationships.

Note that auditor's independence is expected to be higher in this transactional strategy as they are not dependent on the clients, allowing them to uphold their scepticism. However, being overly sceptical may

discourage client cooperation and hinder the audit process, as auditors require complete information (Rennie et al. 2010). Fontaine (2011) contended that auditors tend to favour a transactional strategy when providing only audit services and a relational strategy when offering additional non-audit services. Therefore, clients who accept additional non-audit services indicate their comfort with the auditor's services, fostering a healthy environment for company growth and indirectly revealing the close relationship between auditor and client. According to network theory, a relationship forms when each party benefits from that relationship (Wolff & Kim 2012; Gibson et al. 2014; McCallum et al. 2014). Therefore, maintaining a balanced power dynamic between auditors and clients is vital for preserving scepticism and fostering a productive relationship. When auditors establish dominance and a positive rapport with clients, a developed healthy relationship encourages open discussions about company matters, aiding auditors in identifying fraudulent transactions. Thus, auditor dominance in the auditor-client relationship is necessary to safeguard against fraud risks.

In addition to auditor relational strategy and fraud risk, several variables are discovered to be associated with fraudulent financial statements, mainly the company-specific characteristics, including company size (Hashmi et al. 2020), leverage (Hoang & Phung 2019), growth (Cesinger et al. 2018), and Return on Assets (Tahir et al. 2020). At the same time, corporate governance and audit quality attributes like the Board of Directors (Pucheta-Martínez & Gallego-Álvarez 2019), Audit Committee (Velte 2017), and audit quality (Harris & Williams 2020) play a critical role in shaping a company's financial health and reducing fraudulent risk. These variables help ensure that the relationship between auditor relational strategy and fraud risk is not confounded by the variables absentee, providing a more accurate assessment of the factors influencing fraudulent financial statements.

Despite Fontaine's (2011) assertion that auditor relational strategy may lead to a close auditor-client relationship and a reduction in auditor scepticism, a previous study in Malaysia confirmed that auditors could maintain scepticism in a close relationship (Rahmat et al. 2021). This study consistently highlighted the benefits of a close auditor-client relationship, such as auditors gaining a deeper understanding of the audited company through information sharing, a crucial aspect of the auditing process (Arens et al. 2007). Considering the inconclusive evidence, further research is necessary to assess the impact of auditor relational strategy on the risk of fraudulent financial statements. Therefore, we propose the following hypothesis:

H_1 There is a negative relationship between auditor relational strategy and the risk of fraudulent financial statements.

RESEARCH METHODOLOGY

SAMPLE SELECTION AND DATA

This study utilises data from the period between 2013 and 2017, focusing on companies listed on Bursa Malaysia. The sample is limited to data collected until 2017 to minimise the impact of the latest corporate governance reform related to disclosure behaviour revamped in 2017 and 2021. Nevertheless, we argue that the results remained relevant to date due to the following reasons: (i) the assessed association is yet to be proven, and (ii) there are no significant changes in regulations and audit market structure that make the auditing practice also change drastically during the study period. This approach is crucial to ensure that all samples are subject to consistent enforcement of corporate governance and the accounting profession to eliminate or minimise the impact of new changes in auditor rotation regulations introduced in 2018. Notably, the new rotation policy allows the audit firm partner to be appointed by clients for a maximum of seven years instead of five years during the testing period.

Since most of the data was unavailable in digital databases, information on audit tenure, non-audit fees, ownership structure, and corporate governance structure was manually extracted from annual reports. Financial firms were intentionally excluded from the sample due to the specific and stringent regulatory requirements that set them apart from other industries (David et al. 2020). Moreover, we also excluded any companies with incomplete or missing data or observations. The final sample consisted of 578 companies, with 2,890 observations over five years.

RESEARCH MODEL

A panel data analysis with cross-section fixed and period effects was used to examine the hypothesis. The results of the Haussmann tests and a redundant likelihood chi-square test (not tabulated) suggested that the fixed effect models were appropriate for the regressions. The cross-sectional fixed effects approach increases the Durbin-Watson statistic, minimising autocorrelation issues in the model. The regression models are as follows:

$$RFFS_{i,t} = \beta_0 + \beta_1 ARS_{i,t} + \beta_2 Size_{i,t} + \beta_3 Lev_{i,t} + \beta_4 Growth_{i,t} + \beta_5 ROA_{i,t} + B_6 BOD_{i,t} + \beta_7 AC_{i,t} + \beta_8 DOS_{i,t} + \beta_9 AQ_{i,t} + \beta_{10} Ten_{i,t} + \beta_{11} \Sigma^5_{i,t} Year_{i,t} + \beta_{12} \Sigma^6_{i,t} Ind_{i,t} + \varepsilon_{i,t,} \quad (1)$$

where RFFS is a risk of fraudulent financial statements measured by the Z-score value of the Altman Z-score formula. Z-score is used as it is a well-established tool for predicting financial distress, which can be a strong indicator of potential fraud. Note that companies under financial pressure may resort to fraudulent practices to conceal their actual financial condition, making the Z-score a useful measure in assessing fraud risk (Altman 1968; Kukreja et al. 2020). It offers a balance of simplicity and precision, making it a preferred tool over more complex models such as Beneish and Dechow. Furthermore, the Z-score's straightforward linear formula makes it easy to implement and interpret, providing clear results that help financial practitioners, investors, and decision-makers assess risk quickly and effectively. Additionally, research by Azhar et al. (2021), Bhavani and Amponsah (2017), and others supported the Z-score's effectiveness in identifying the risk of financial statement fraud (RFFS), making it an ideal instrument for studies requiring efficient financial risk evaluation.

ARS is an auditor relational strategy measured by a dummy variable that equals "1" if the percentage of the non-audit service to total fees is 14% or above and "0" otherwise. Non-audit fees are used as a proxy for auditor relational strategy since they reflect the increased interaction and dependency between auditors and clients. This potentially compromises auditor independence and objectivity, as higher fees from non-audit services can indicate a closer, more embedded relationship, which may affect judgment and fraud risk (Fontaine 2011; Fontaine & Pilotti 2016; Lennox 2016). Furthermore, the more non-audit fees received from clients may indicate the auditor's willingness to have a close relationship with clients, which is aligned with the relational strategy. This measurement aligns with Fontaine (2011) as well as Fontaine and Pilotti (2016), who employed non-audit fees as an indicator to assess the relationship between auditors and their clients.

We also include control for other factors that may influence the dependent variable, mainly factors that could represent the differential of company attributes and corporate governance practices. The company's attributes include Size, Lev, Growth, and ROA. Size is a firm's size, measured by a natural logarithm of its book value of total assets (Rahmat & Ali 2016). Meanwhile, Lev is a company's leverage, scaled by total debt ratio over total assets (Rahmat & Ali 2016). Gaio and Raposo (2011) also highlighted that a company's poor performance is associated with lower earnings quality. The cross-sectional differential company's performance effect through *Growth* is controlled, which is measured by revenue at the end of the year *t* divided by revenue year *t*-1 (Rahmat & Ali 2016). ROA is measured using earnings before interest and tax divided by total assets (Ahmed & Hamdan 2015).

The corporate governance characteristics are the size of the board of directors (BOD) and the audit committee (AC), which may also influence the fraud risk to the companies. Strong corporate governance is associated with improved transparency and reduced fraud risk, making it a critical control variable in studies related to corporate behaviour and financial performance (Krause et al. 2014; Larcker & Tayan 2020). BOD is measured by the actual number of directors on board. AC stands for AC independence and is measured by the proportion of non-executive AC members divided by the total number of AC members (Othman et al. 2015). Note that DOS is a direct ownership shareholding measured by the percentage of direct ownership owned by the controlling shareholders (Ahmed & Hamdan 2015). In addition, AQ is represented by a binary variable, with a value equal to "1" if a Big 4 auditor audits a company and "0" otherwise. At the same time, Ten denotes auditor tenure reappointments measured by a dummy variable, with a value equal to "1" if the clients reappoint the auditor for four or more consecutive years and "0" otherwise (Garcia-Blandon & Argiles 2017). The type of auditor (Big 4 vs. non-Big 4) and reappointment tenure affect AQ and may influence the auditor's ability to detect fraudulent financial statements (Harris & Williams 2020). Thus, the impact must be controlled to prevent the results from confounding. Additionally, the differential effect of *Year* and *Industry* is controlled using the panel least-squares, cross-section, and period fixed effects (Hawtrey & Liang 2008). Note that ε is the error term.

RESULTS

RESULTS FOR DESCRIPTIVE STATISTICS

Table 1 provides descriptive statistics based on 2,890 observations. All continuous variables are winsorised to 1% at the top and bottom. The mean (median) of RFFS is 1.40 (1.39), indicating that, on average, companies in the study tend to engage in manipulative transactions or possess a risk of fraud. Table 1 also indicates that 2,128 (74%) companies maintain a close relationship with their auditors, as evidenced by consecutive reappointments lasting four years or more following the first year of engagement. Additionally, the mean (median) for ARS is 0.41 (0.00), indicating that, on average, companies utilise additional services provided by auditors. This implies a potential dependency between auditors and clients.

TABLE 1. Descriptive analysis

Panel A	Mean	Median	Maximum	Minimum	Std. dev.
RFFS	1.40	1.39	6.53	-4.29	1.09
ARS	0.41	0.00	1.00	0.00	0.49
Size	5.72	5.66	7.83	3.87	0.64
Lev	0.19	0.16	0.76	0.00	0.16
Growth	0.00	0.00	0.12	-0.12	0.03
ROA	0.06	0.05	0.52	-0.43	0.10
BOD	7.30	7.00	13.00	3.00	1.82
AC	0.89	1.00	1.33	0.40	0.15
DOS	51.29	53.79	98.01	16.80	16.63
Panel B	Frequency	(%)			
AQ	1452	50			
Ten	2128	74			

Notes: RFFS is a risk of fraudulent financial statements measured by the Z-score value of the Altman Z-score formula. ARS is an auditor relational strategy, measured by a dummy variable with a value equal to "1" if the percentage of the non-audit service is 14% or more and "0" otherwise. Size is a firm's size, measured by a natural logarithm of its book value of total assets at year-end. Lev is a company's leverage scaled by total debt ratio over total assets. Growth is measured by revenue at the end of the year t divided by revenue year t-1. ROA is the return on assets measured using earnings before interest and tax divided by total assets. BOD is a board of directors measured by the actual number of directors on board. AC is an audit committee, measured by the proportion of the number of non-executive audit committee members divided by the total number of audit committee members. DOS is a direct ownership shareholder, measured by the percentage of shares by direct ownership shareholders. AQ is a binary variable representing audit quality, with a value equal to "1" if a firm is audited by a Big 4 auditor or "0" otherwise. Ten is audit firm tenure reappointment, measured by a dummy variable, with a value equal to "1" if the clients reappoint the auditor for four or more consecutive years and "0" otherwise.

We also conducted Pearson's correlation, as presented in Table 2, and the results indicate that no variable is highly correlated with any other. The highest correlation is between RFFS and ROA (0.69). The Variance Inflation Factors (VIF) test further confirms that multicollinearity is not an issue, as the value for all variables is below 10 (Neter et al. 1983). Table 2 also demonstrates that an ARS is positively associated with Size, ROA, BOD, DOS, AQ, and Ten and negatively associated with AC.

TABLE 2. Pearson correlation matrix

Probability	RFFS	ARS	Size	Lev	Growth	ROA	BOD	AC	DOS	AQ	Ten	VIF
RFFS	1											
ARS	0.08***	1										1.02
Size	0.04**	0.13***	1									1.20
Lev	-0.27***	0.01	0.37***	1								1.19
Growth	0.18***	0.03	0.06***	0.02	1							1.09
ROA	0.69***	0.08***	0.14***	-0.12***	0.23***	1						1.16
BOD	0.12***	0.08***	0.38***	0.15***	0.05***	0.12***	1					1.02
AC	0.01	-0.04**	-0.07***	0	0.02	-0.06***	0.05***	1				1.00
DOS	0.16***	0.06***	0.16***	-0.05***	0.05**	0.14***	0.12***	-0.04*	1			1.01
AQ	0.09***	0.23***	0.41***	0.11***	0.01	0.11***	0.14***	-0.14***	0.18***	1		1.07
Ten	0.11***	0.11***	0.17***	-0.01	0.03*	0.11***	0.04**	-0.01	0.08***	0.26***	1	1.05

Notes: Refer to Table 1 for variable definition and measurement. VIF is the variance inflation factor. ***Significant level $p < 0.01$, ** Significant level < 0.05, *Significant level $p < 0.10$.

REGRESSION RESULT

The fixed effect panel, a data regression model, examines the relationship between close auditor relational strategy and the risk of fraudulent financial statements. The results are summarised in Table 3. The adjusted R^2 of the model is 94%, consistent with the panel least-squares estimation with cross-sectional and period-fixed effects (Hawtrey & Liang 2008). The Durbin-Watson value for Equation 1 is 1.43, indicating that the model is free of autocorrelation issues. Table 3 indicates that the coefficient of ARS is negative, -0.03 (t = -2.98), and significant at a level $p < 0.01$ which supports H_1. As such, auditor relational strategy will improve trust and commitment, make clients more comfortable with their auditors, and make them more willing to voluntarily share corporate information that the auditors require. As long as auditors maintain their scepticism, a close relationship does not threaten the risk of fraudulent financial statements. These findings are consistent with Rahmat et al. (2021), who also discovered that auditors are more likely to retain the same client over an extended period and can still maintain their scepticism.

TABLE 3. Regression analysis

Variables	Coefficient	t-statistic
Constant	-2.08	-4.60***
ARS	-0.03	-2.98***
Size	0.52	7.16***
Lev	-1.69	-19.54***
Growth	1.56	9.03***

ROA	4.58	17.87***
BOD	0.01	2.31**
AC	0.18	3.13***
DOS	0.00	8.56***
AQ	0.15	3.64***
Ten	0.03	1.92*
Adjusted R2	94%	
F-statistic	64%	
Durbin-Watson	1.43	
n	2890	

Notes: Refer to Table 1 for variable definition and measurement. The model is regressed using panel least-squares estimation with cross-section fixed and period effects. We report t-statistics based on White's (1980) consistent estimator. ***Significant level p < 0.01, ** significant level < 0.05, *significant level p < 0.10

The result reveals that while a close auditor-client relationship might facilitate better information sharing, which is essential for detecting fraudulent activities, auditors do not become complacent. The negative coefficient of ARS suggests that even with a high level of relational engagement, auditors who maintain their scepticism can effectively mitigate potential risks associated with close relationships. This aligns with the findings of Rahmat et al. (2021), which demonstrated that auditors who retain long-term clients are still able to uphold their scepticism. Our results underscore the significance of balancing relational strategies with rigorous audit practices to ensure trust and information sharing do not compromise audit quality. Moreover, these findings suggest that auditor relational strategies can enhance the audit process by fostering an environment where clients are more willing to provide necessary information, thereby aiding in detecting fraudulent transactions. However, the effectiveness of this strategy is contingent upon the auditor's ability to preserve their independence and scepticism. This nuanced understanding is crucial for refining audit practices. It contributes to the broader discourse on auditor-client relationships and their impact on audit quality. Regarding the control variables, Table 3 reveals that all control variables are statistically significant and positive, except for Lev, which is negatively significant.

SENSITIVITY ANALYSIS

The following additional sensitivity tests were conducted to increase our understanding of the relationship between the variables as robustness checks. The first objective of this sensitivity is to determine the impact of high audit quality on auditor relational strategy and the risk of fraudulent financial statements. We conducted additional regression analysis by excluding companies audited by non-Big 4 auditors to align with Gallery et al. (2008) and Bennouri et al. (2015), who previously reported that Big 4 auditors could help lessen the risk of fraud. However, they ignored the potential impact of networking relationships. The results are presented in Table 4. The result reveals insignificant towards the ARS and RFFS. This lack of evidence suggests that the auditor relational strategy employed by Big 4 auditors may not influence the risk of fraudulent financial statements. Based on these findings, it can be concluded that having a Big 4 auditor does not necessarily guarantee the best level of service, contrary to the suggestions made in some previous studies by Enofe et al. (2013) and Salehi et al. (2008).

TABLE 4. Analysis of big 4 auditors and RFFS

Variables	Coefficient	t-statistic
Constant	-0.25	-0.27
ARS	-0.01	-0.34
Size	0.21	1.55
Lev	-1.58	-12.53***
Growth	1.85	5.29***
ROA	4.65	19.93***
BOD	0.02	3.80***
AC	0.17	2.47**
DOS	0.00	2.83***
Ten	0.07	3.95***
Adjusted R2	96%	
F-statistic	95%	
Durbin-Watson	1.55	
N	1452	

Notes: Refer to Table 1 for variable definition and measurement. The model is regressed using panel least-squares estimation with cross-section fixed and period effects. We report t-statistics based on White's (1980) consistent estimator. ***Significant level p < 0.01, **Significant level < 0.05, *Significant level p < 0.10

The second objective is to determine the level of auditor relational strategy and risk of fraudulent financial statements, specifically to observe whether there is a potential for a non-linear relationship at a higher percentage level. The results are summarised in Table 5.

TABLE 5. Analysis of ARS percentage comparison

% of ARS	14%		50%		51%		60%	
Variable	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic
Constant	-2.08	-4.60***	-2.12	-4.55***	-2.12	-4.57***	-2.13	-4.58***
ARS	-0.03	-2.98***	-0.05	-2.09**	-0.03	-0.99	0.01	0.77
Size	0.52	7.16***	0.53	7.06***	0.53	7.09***	0.53	7.12***
Lev	-1.69	-19.54***	-1.69	-20.06***	-1.69	-19.72***	-1.68	-19.61***
Growth	1.56	9.03***	1.56	8.85***	1.56	8.76***	1.55	8.87***
ROA	4.58	17.87***	4.59	17.78***	4.59	17.78***	4.58	17.83***
BOD	0.01	2.31**	0.01	2.23***	0.01	2.26**	0.01	2.32**
AC	0.18	3.13***	0.19	3.20***	0.19	3.20***	0.19	3.16***
DOS	0.00	8.56***	0.00	8.69***	0.00	8.56***	0.00	8.60***
AQ	0.15	3.64***	0.14	3.22***	0.14	3.22***	0.14	3.24***
Ten	0.03	1.92*	0.02	1.94*	0.02	1.95*	0.03	1.95*
Adjusted R2	93%		93%		93%		93%	
F-statistic	64%		64%		64%		64%	
Durbin-Watson	1.43		1.43		1.43		1.43	
N	2890		2890		2890		2890	

Notes: Refer to Table 1 for variable definition and measurement. % of ARS measured by (non-audit fee/total fee) x 100. Dummy variables were employed at four different levels of percentage: value "1" if the percentage of non-audit service was 14% or more and "0" otherwise, value "1" if the percentage of non-audit service 50% or more and "0" otherwise, value "1" if the percentage of non-audit service 51% or more and "0" otherwise; value "1" if the percentage of non-audit service 60% or more and "0" otherwise. The model is regressed using panel least-squares estimation with cross-section fixed and period effects. We report t-statistics based on White's (1980) consistent estimator. ***Significant level $p < 0.01$, **Significant level < 0.05, *Significant level $p < 0.10$.

To accomplish this, we employed dummy variables at different percentage levels, with a value of "1" if the percentage of non-audit service is 14% or more and "0" otherwise. Value "1" if the percentage of non-audit service is 50% or more and "0" otherwise. Meanwhile, the value "1" is if the percentage of non-audit service is 51% or more and "0" is otherwise. Value "1" if the percentage of non-audit service is 60% or more and "0" otherwise. This analysis aims to determine whether a higher percentage of auditor relational strategy reduces the risk of fraudulent financial statements or vice versa. Referring to Table 5, it is evident that a higher percentage of ARS is associated with a reduced risk of fraudulent financial statements. Moreover, the higher the percentage of additional services offered, i.e., specifically between the range of 15% to 50%, indicates that the auditor has gained the trust of their clients. The clients are more willing to share their corporate information with the auditor. Thus, it supports the study by Rahmat et al. (2021), which indicated that auditors who maintain close relationships are able to maintain their scepticism. However, the result is insignificant if additional services are 51% and above. The result agreed with Fontaine (2011), indicating that auditors become economically dependent on the client if they receive excessive additional services, potentially reducing the scepticism and increasing the risk of fraud. Thus, our findings reveal a nuanced relationship between auditor relational strategy and fraud risk. This demonstrates that while moderate engagement through additional services can be beneficial, excessively high levels of such services may have detrimental effects. Accordingly, these results underscore the significance of balancing auditor-client relationships to maintain effective audit practices and the necessary scepticism to prevent fraud.

SUMMARY AND CONCLUSION

We investigated the impact of auditor's attributes, based on network theory, i.e., auditor relational strategy, on the risk of fraudulent financial statements. We posited that the appropriate employment of an auditor relational strategy throughout the audit-client relationship might influence the risk of fraudulent financial statements. Consequently, we are concerned that auditor relational strategy could influence clients' comfortability and willingness to voluntarily share corporate information with auditors. Since audits heavily rely on information from clients, auditors' ability to detect fraud could be affected. In principle, the quality of a close audit-client relationship depends on the auditor's ability to maintain independence and objectivity throughout the audit. Rahmat et al. (2021) asserted that auditors can still maintain their scepticism even when they are more likely to retain the same client over a long period.

Our findings generally conclude that when an auditor's relational strategy is employed, and auditors maintain their scepticism while interacting with clients, it reduces the risk of fraudulent financial statements. This suggests that providing additional value through non-audit services allows auditors to create an environment conducive to receiving comprehensive information from their clients, enabling them to detect fraudulent transactions within the company. Additionally, this aligns with network theory, where clients intentionally maintain long-term relationships with auditors to establish a close auditor-client relationship. Hence, continuing these appointments naturally fosters strong interpersonal bonds between the client and auditor (Meyer et al. 2007; Ball et al. 2015) and allows auditors to detect fraud. For instance, the case of Enron is instructive. The close relationship between Enron and its auditor, Arthur Andersen, contributed to the failure to detect and report fraudulent financial activities. This case demonstrates the pitfalls of an overly familiar relationship without sufficient scepticism, highlighting the significance of balancing relational engagement with professional integrity.

Furthermore, our study's results extend the understanding from prior research on auditor-client relationships. Fontaine (2011) as well as Fontaine and Pilotti (2016), noted that while a close relationship might increase the likelihood of auditors receiving more detailed information, it also risks compromising auditor independence. This is illustrated by the WorldCom scandal, where the relationship between WorldCom and its auditor, Deloitte and Touche, did not prevent the massive financial fraud from being overlooked. Our findings build on this by demonstrating that while non-audit services can enhance information sharing, auditors must maintain a balance to prevent compromising their independence and scepticism. Overall, our findings are robust after controlling various aspects, such as corporate governance and firm ownership structures, and we have included several sensitivity analyses. The results confirmed our concern that the previous evidence by Gallery et al. (2008) and Bennouri et al. (2015) might not fully consider the potential influence of human behaviour when discussing auditor relational strategy. In particular, the Satyam Computers case exemplifies this issue. Despite strong relational ties between Satyam and its auditors, PricewaterhouseCoopers, the auditors failed to detect the company's financial irregularities. This case underscores the need for auditors to manage relationships carefully and maintain objectivity to minimise the risk of fraudulent transactions.

In summary, it can be concluded that auditor relational strategy depends on the auditor's ability to withstand independence and objectivity throughout the audit. This is consistent with the study by Rahmat et al. (2021), which supported long-term audit tenure and close auditor-client relationships while maintaining scepticism. Accordingly, we provide new knowledge in the auditing field to better understand the network relationship between auditors and clients by applying the auditor relational strategy. The fresh evidence suggests that an auditor's relational strategy can potentially mitigate the risk of fraudulent financial statements even after embedding an established and close networking effect between auditor and client. In addition, we conclude that the auditor with a relational strategy could endeavour to explore the equilibrium between scepticism and cooperation while performing the audit works. In contrast to Fontaine (2011) and Fontaine and Pilotti (2016), the auditor's relational strategy encourages clients to voluntarily share their corporate information, reducing the risk of fraudulent financial statements. Thus, the auditor's relational strategy may not always represent a negative position. Instead, it helps auditors enhance their audit work while maintaining the integrity of financial reporting.

These findings may raise some concerns in practice, as auditor relational strategy could potentially compromise auditors' ability to detect fraud, as Fontaine (2011) claimed. Therefore, the study suggests that the audit committee should play a role by regularly assessing auditor relational strategy to ensure that the risk of fraud remains manageable. Furthermore, periodic evaluations may be necessary to ensure that the auditor's relational strategy remains balanced and benefits both parties. Moreover, an updating the rules and regulations by policymaker may be warranted to ensure that auditors provide their services with professional conduct. This includes strengthening the requirement for professional scepticism in high-risk situations, enforcing stricter rules on auditor independence to prevent over-familiarity with management, mandating regular fraud detection training, and clarifying the obligation to report suspicions of fraud even before they result in material misstatements. Accordingly, these changes would enhance auditors' ability to identify and address potential fraud risks effectively (Tepalagul & Lin 2015). Overall, the findings indicate that both auditors and clients need each other. Therefore, auditors should understand how to manage and influence clients in a close auditor-client relationship, ensuring they maintain independence and objectivity throughout the audit.

The study is subject to a few limitations. First, the study uses non-audit fee data to measure auditor relational strategy, reflecting the added value that auditors provide to their clients. However, it is possible that this measurement may not fully reflect the actual state of auditor relational strategy since it is more based on perception or assumption. Other measurement methods, such as interviews or questionnaires, could be considered to assess auditor relational strategy more comprehensively. Second, we focused only on Malaysia-listed firms, which are relatively smaller in scale. Hence, our findings might not readily apply to companies beyond the Malaysian context. Future studies may consider comparing a similar issue in other country settings.

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