Internal Governance Structure and External Audit Fee in Malaysia

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ABSTRACT

Internal governance structure plays a role in improving quality of financial reporting, thus determining external audit fee is very important. The objective of this study is to examine the association between external audit fees and internal governance structure (boards and audit committee characteristics). The methodology used based on the sample of 115 companies listed on the Bursa Malaysia Main Market in 2015. It is hypothesized that external audit fees will be positively associated with board of director and audit committee's independence, expertise and meeting frequency. As a result, the findings reveal that no variable found to be significant to external audit fee except for audit committee expertise (audit committees who being accounting professional members). Audit committee expertise indicate negative and significant relationship with external audit fee which implies that the existence more audit committee member who possess accounting professional certification tend to provide complementary effect towards audit effort in the process of negotiating audit fee, thus lower audit fee will be paid. The study suggests there are opportunities to include other variables such as director's remuneration, ownership structure or /and audit tenure for future research.

Keywords: Corporate Governance, Boards of Directors, Audit Committees, External Audit Fee, Malaysia

INTRODUCTION

Asian financial crisis in 1997-1998 that affected Malaysia and the collapses of big company such as Enron, WorldCom and Tyco have led some improvements of corporate governance mechanisms especially in quality of financial reporting. The Malaysia Code on Corporate Governance (MCCG) and Bursa Malaysia Listing Requirement have stressed on the importance of corporate governance and disclosure requirement. MCGG (2000) and the BMLR (2005) have highlighted the issues of composition of board, the use of board committees, their mandates and their activities especially for corporate sector to comply with.

Accounting scandal and corporate bankruptcies have raised questions about the independence and effectiveness of board of directors and audit committees. An effective functioning board and audit committees are supposed to protect the company and contribute good corporate governance. The boards of directors and audit committees are responsible for the good governance of firm and therefore monitoring the relationship between firm's management and external auditor is one aspect that needs to take into account in considering the improvement of the financial reporting process.

Annual audit is one of the keystones of financial reporting in corporate governance and therefore fees paid to the external auditor for audit services represent an important element of the economic relationship between management and the external auditor as Lee and Mande (2005) claimed.

Board of directors and audit committee's effectiveness and attributes which affects the quality of financial reporting have also impact on the audit related service since an important aspect of financial

reporting process is the statutory audit. One of the possible effects of these attributes to audit related services is towards the negotiation audit fee paid to the external auditor. Based on this explanation, there are two parties (board of directors and audit committees) that could set external audit fee and the issue is which party more influencing in determining the audit fee.

LITERATURE RIVIEW

Fama (1980) and Fama and Jensen (1983) are among the academic literatures that indicating board of directors perform an important corporate governance function and non-executive directors act as necessary monitor of management. Azrul Ihsan et al. (2013) has studied internal governance structure except for audit committee expertise on audit fee. Md. Ali (1994) asserts that even though the boards are responsible for overall stewardship of their organizations' affair including a true and fair presentation of financial information, the existence of audit committee could assist board in the financial affair of the companies. In United Kingdom, Goddard and Masters (2000) have provided an empirical analysis about the effect of audit committee formation that adheres with Cadbury Code towards the determination of audit fee. In Malaysia, Norziaton et al. (2017), study on the audit committee in the politically connected companies with relation to audit fee determination. While Wan Adibah and Khairul Anuar (2012) and Nurul Azlin et al. (2013) have evidence on the association of audit committee expertise and audit fee.

Overall, board of director and audit committee structure are both seem related to aspects of the contracting and monitoring environment. Therefore, this study is purposely done to investigate the effect of board of directors' characteristics and audit committees' characteristics in influencing the external audit fees.

METHODOLOGY

Data Collection and Sample Selection

The empirical work for this study is based on the secondary data collected from annual report using sampling method. The population for this study is 855 companies located in the Main Market of the Bursa Malaysia. The sample comprises the Bursa Malaysia non-financial public listed companies of which annual reports are available in 2015. Finance-related firms were excluded due to their unique characteristics and different compliance and regulatory environment. A total sample of 115 companies were randomly selected by using disproportionate stratified random sampling in order to get more representativeness of data from each industry type segment of the population as suggested by Sekaran (2000). Both financial and corporate data of these firms are obtained from their annual reports. These annual reports are available and downloadable from the web site of the exchange (http://www.bursamalaysia.com).

Variable Measurements and Model Specification

To test the relationship between the variables (dependent and independent variables) a regression analysis has been used in this study. The study employs Ordinary Least Square (OLS) multiple regression analysis. Consistent with existing literature on determinants of audit fees, this study applies the traditional audit fee model introduced by Simunic (1980) and modified by Craswell et al. (1995), Carcello et al. (2002) and Yatim et al. (2006). The natural log of audit fee represents the dependent variable for this study. As for the independent variables, the specific characteristic of board of directors and audit committees (independence, expertise and diligent) is included as the proxies for the internal governance structure. The study also includes controlled variables identified by prior research that explain the cross-sectional variations in audit fee (Simunic and Stein, 1996; Francis and Simon, 1987; Craswell et al., 1995). The controlled variables include natural log of total asset, receivable and inventory intensity to total asset, square root number of subsidiaries and type of auditor to explain for firm size, audit

complexity, audit risk and audit quality respectively. In sum, the following model has been developed to examine the association between audit fees with board of directors and audit committee characteristics:

$$LNAUDFEE = b_0 + b_1\_BODINDP + b_2\_ BODXPRT + b_3\_BODMEET + b_4\_ACINDP + b_5\_ACXPRT + b_6\_ACMEET + b_7\_LNASSET + b_8\_INVRECTA + b_9\_SQSUBS + b_{10}\_BIG4 + e \quad (1)$$

Where

Dependent Variable: LNAUDFEE = Natural log of audit fees,
Hypotheses Variables: H1: BODINDP = Proportion of independent director on the board, H2: BODXPRT = Proportion of directorship on the board, H3: BODMEET = Total number of board of director meeting during the financial year, H4: ACINDP = Proportion of audit committee which consist independence director, H5: ACXPRT = Proportion of audit committee which being accounting professional member, H6: ACMEET = Total number of audit committee meeting during the financial year,
Controlled Variables: LNASSET = Natural log of total assets, INVRECTA = Ratio of inventories and receivables to total assets, SQSUBS = Square root of the number of subsidiaries, BIG4 = A dummy variable of 1 if financial statements audited by Big 4 audit firm, 0 otherwise,

b_0 = Constant term
$b_1 \ldots b_{10}$ = regression coefficient,
e = Error term

Dependent Variable

The dependent variable LNAUDFEE is the fees paid to external auditors for audit services. The Malaysia Companies Act 1965 requires companies to disclose their audit fee in their notes to account. The figure was therefore had collected from company annual reports and notes to the account. The fees are then transformed into natural logarithm. The natural log is used to control for the skewed nature of audit fees as found in previous studies that audit fees was not normally distributed (Goddard and Master, 2000). By transforming the audit fee into natural logarithm, the dependent variable LNAUDFEE was approximately normally distributed.

Independent/Hypotheses Variables

Board of Directors Variables

The experimental variables of board of directors are tested for the first part of hypotheses. Consistent with prior studies, this study test whether more independent, expert and diligent of board of directors could lead to more external audit fee paid. The measure for board independence for this study is the proportion of non-executive directors on boards. An independent non-executive director is a director who is relatively free from conflict of interest and better able to protect the owners' interest (Monks and Minow, 1995). Next, the measure for expert board of director is by using the director interlocking or multiple directorships. Kaplan and Reishus (1990) and Carcello et al. (2002) support the view that the number of directorships may serve as an indicator of directors' expertise. Thus, it is anticipated that the multiple directorship of board would demand high quality of audit and ultimately lead to higher external audit fee paid. Board of director's diligent is measured by the total number of board meeting held during the financial year. The more diligent the director, the higher external audit fee is.

Audit Committees Variables

The second parts of hypotheses are developed to test the relationship between audit committee characteristics with external audit fee. It is asserted that more independent, more expert and more diligent of audit committee characteristics lead to more external audit fee paid. Audit committee independent is measured by the proportion of non-executive directors on the audit committee member. Meanwhile, the audit committee expert is measured by the proportion of audit committee members with MIA qualification or other accounting qualification that have been stated by Bursa Malaysia Listing Requirement (2005). Finally, the proxies used to measure audit committee diligent is the frequency of audit committee meetings held during the financial year.

Controlled Variables

As concluded by Simunic (1980), the magnitude of audit fee also varies on client size, audit risk, complexity of operations and audit quality. Hence, this study employs these variables as controlled variables to represent these factors which include natural log of total assets, ratio of inventories and receivables to total assets, square root the number of subsidiaries, and classification big 4 or non-big 4 type of audit firm.

The use of natural log to total assets is to proxy for client size. Client size is the most widely used variable across prior literature (e.g: Simunic, 1980; Chan et al., 1993; Che Ahmad and Derashid, 1996; O'Sullivan, 2000) since a larger client size require more audit effort (Simunic, 1980).
Next, audit risk is claimed to influence audit fee since the scope of audit work is based on the audit risk model. Higher audit risks lead to more audit work or effort which ultimately result in a higher audit fee. Based on the study carried out by O'Sullivan (2000) and Carcello et al. (2002), the sum of receivables and inventory to the proportion of total assets is used as a measure for audit risk because companies with higher amount of assets are perceived to have higher risk and there is need to take into account the possibility of bad debt and obsolete stock.

Then, the square root of the total number of subsidiaries is utilized to set for auditee complexity. Even though Chan et al. (1993) argue that the total number of subsidiaries is unlikely to be entirely satisfactory proxy for audit complexity, however a study by Che Ahmad and Derashid (1996) found a significant relationship between the total number of subsidiaries and audit fee. Therefore, this study employs the number of subsidiaries a proxy for auditee complexity.

Finally, a variable of BIG4 is used to represent firms audited by the big 4 firm or non-big 4 in order to examine whether there is differential pricing exists between the two categories of firms in Malaysia listed companies. Prior studies by Palmrose (1986) and Craswell and Francis (1999) suggest the pricing for audit fees is influenced by the type of audit firm because big 4 firms are able to charge premium as a result of better reputation than non-big 4.

RESULTS AND DISCUSSION

Descriptive Statistics

Descriptive Statistics of Hypothesis Variables

Table 1 provides descriptive statistics for hypothesis variables. The results reveal that the companies in the sample paid external audit fee with an average of RM 152,881. Natural log of audit fee (LNAUDFEE) is in the range from 9.6 to 14.5 with average 11.4. Of particular interest to this study are internal governance structure characteristics. By referring to the descriptive table above, the average number of

non-executive directors on board for this sample is 2.97 ranging from a minimum of 2 to a maximum of 8. There is maximum number of 11 boards of director who hold multiple directorships for this sample and a minimum number of one. On average, the boards of directors have met five times during the financial year which the most frequent met is 17 times while the least frequent board meeting is only once.

Table 1**: Descriptive Statistics of Hypothesis Variables (N=115)**

	Minimum	Maximum	Mean	Std. Deviation
AUDFEE(RM)	15,000	1,995,000	152,880.89	269,287.546
LNAUDFEE	9.62	14.51	11.4384	.84035
BODSIZE	3	18	7.32	2.281
BODINDP	2	8	2.97	1.042
BODXPRT	1	11	4.35	2.069
BODMEET	1	17	5.28	2.273
ACSIZE	3	7	3.36	.678
ACINDP	2	4	2.35	.496
ACXPRT	0	3	1.03	.512
ACMEET	1	10	4.83	1.184

As for audit committee characteristics are concerned, the Bursa Malaysia Listing Requirement (2001) require that all public listed companies to have audit committees comprising at least three members which the majority of them are independent. Based on the descriptive statistic results, on average the independent of audit committee is two for this sample of study. Bursa Malaysia Listing Requirement (2001) also mandate that at least one of audit committee member be MIA member; or at least 3 years working experience and must have passed the examinations specified in Part I of the 1st Schedule of the Accountants Act 1967; or must be a member of one of the associations of accountants specified in Part II of the 1st Schedule of the Accountants Act 1967. From the result, it shows that there are still have companies which establish audit committee with no financial qualification that has been stipulated by Bursa Malaysia Listing Requirement. From this study, on average the companies have one audit committee with accounting expertise. Then, the standard number of audit committee meeting held during the financial year for this study is five times with a minimum of one and a maximum of 10.

Descriptive Statistics of Controlled Variables

Table 2 provides descriptive statistics for the controlled variables employed in the model. The mean total asset is approximately RM 653,695,460. The descriptive statistics also reveal that Malaysia parent companies for this study have a maximum number of 103 subsidiaries in a group and a minimum of one. On average, the number of subsidiaries is seventeen. There are 57% of the companies from the sample use big four external auditors. For natural log of total asset (LNASSET), it shows the range from 12.8 to 23.8 with average at 19.3. With respect to the ratio of inventory and receivables to total asset (INVRECTA), it indicates that the lower figure is 0.00:1 to a higher ratio of 1:1. On average the companies have 0.3:1 of INVRECTA. As for the square root of subsidiaries (SQSUBS), it ranges from 1 to 10 with average of 3.7.

Table 2: Descriptive Statistics of Controlled Variables (N=115)

	Minimum	Maximum	Mean	Std. Deviation
TASSET (RM)	9,752,833	21,905,572,097	653,695,459.83	2,113,782,249.920
NOSUBS	1	103	17.17	18.113
BIG4 (dummy)	0	1	.57	.498
LNASSET	12.79	23.81	19.3195	1.29638
INVRECTA	.00	1.00	.3008	.21003
SQSUBS	1.00	10.15	3.7485	1.77244

Correlation Analysis

Table 3 illustrates the result of the Pearson correlations between the variables used in the OLS regression. The results indicate the relationship between the explanatory variables used in the multivariate regression as well as measuring the significance and the direction of the relationship. The correlation matrix reveals that few variables are highly inter-correlated (above 0.5). There are two variables are significantly correlated with external audit fee which are natural log of total asset (0.521) and the square root number of subsidiaries (0.765). The natural log of asset as a proxy for auditee size is found to be significantly correlated with audit fee is consistent with prior studies by Che Ahmad and Derashid (1996), O'Sullivan (2000) and Yatim et al. (2006). This suggests that larger firms require greater audit effort, thus the audit fee will be higher. Another variable is square root of subsidiaries which is highly correlated with audit fee and this is expected since auditors should take more time and effort to carry out audit work when client structure is more complex. This finding is consistent with previous studies by Chan et al. (1993) and Carcello et al. (2002). Apart from that, among governance structure variables, few board and audit committee characteristics are significantly correlated with each other which range from 0.359 (between board independence and audit committee independence) to 0.46 (between the frequency of board meetings and audit committee meetings). But these correlations do not indicate that multicollinearity is a serious problem as per Besley et al. (1980) suggested.

Table 3: Pearson Correlation Matrix of Variables (N=115)

	LNAUDFEE	LNASSET	INVRECTA	SQSUBS	BIG4	BODINDP	BODXPRT	BODMEET	ACINDP	ACXPRT	ACMEET
LNAUDFEE	1	.521(**)	-.122	.765(**)	.086	.105	.067	.214(*)	.016	-.089	.153
		.000	.194	.000	.361	.262	.478	.021	.862	.346	.104
		115	115	115	115	115	115	115	115	115	115
LNASSET		1	-.279(**)	.278(**)	.106	.012	-.039	.168	.064	-.022	.115
			.003	.003	.259	.896	.679	.073	.495	.812	.220
			115	115	115	115	115	115	115	115	115
INVRECTA			1	-.061	-.122	.018	-.106	-.157	-.060	-.086	-.071
				.517	.194	.849	.260	.093	.522	.359	.449
				115	115	115	115	115	115	115	115
SQSUBS				1	.064	.165	.034	.290(**)	-.050	-.015	.174
					.500	.078	.722	.002	.595	.870	.063
					115	115	115	115	115	115	115
BIG4					1	-.188(*)	.098	.046	.025	.114	-.034
						.044	.299	.627	.795	.225	.721
						115	115	115	115	115	115
BODINDPER						1	.098	-.016	.359(**)	-.212(*)	.178
							.300	.869	.000	.023	.058
							115	115	115	115	115
BODXPRTPER							1	.031	-.066	.014	-.019
								.746	.486	.886	.840
								115	115	115	115
BODMEET								1	-.133	.078	.460(**)
									.155	.410	.000
									115	115	115
ACINDPER									1	.063	.038
										.501	.689
										115	115
ACXPRTPER										1	-.092
											.329
											115
ACMEET											1

Multivariate Analysis

Regression results of the association between external audit fees and internal governance structures

Table IV reports the ordinary least square regression results to test the effect of all variables. The model is significant ($p<0.01$) with R^2 of 70.1 percent. The results for this testing are discussed as follows. As far as internal governance structures are concerned, the results show that these hypotheses variables are generally not significant. A closer examination to board of directors' characteristics and audit committee characteristics reveal that there is a weak evidence that audit committee expertise is associated with external audit fee ($p<0.1$). Hypothesis 5 (audit committees' expertise) for this study predicts that a positive association between external audit fee and audit committee expertise. However, the result shows a significant negative relationship between audit committee expertise and external audit fee which is in contrast with Abbott et al. (2003). One possible explanation with respect to the significant negative association between audit committees' expertise and external audit fee is that the existence of more audit committee expertise would provide complementary effect towards audit effort since they could detect, know and understanding better about various issues in accounting and auditing. Then, this would lead to the reduction of auditors' risk assessments associated with the financial reporting process as posited by Yatim et al. (2006) and as such may result in lower external audit fee.

Other hypotheses variables signify that the results are not significant. Audit committee independence (as measured by proportion of independent directors on audit committee members) and audit committees diligent (as measured by the number of audit committee meeting during the financial year) show positive indicators of external audit fee. This insignificant association between audit committee diligent and external audit fee is consistent with Abbott et al. (2003) but not on the audit committee independence. Meanwhile, board of director independent (as measured by proportion of independent directors on boards) and board of director diligent (as measured by the number of board meeting during the financial year) are not significant and negatively related to external audit fee. Therefore, H1 (boards' independence) and H3 (boards' meeting) are not supported and in contrast with Carcello et al. (2002). Hypothesis 2 (boards' expertise) predicts that there is positive association between external audit fee and board of directors who hold multiple directorships, thus H2 (boards' expertise) is supported albeit weak. The finding for board of director's expertise as a variable of board characteristics is positively related in determining external audit fee is consistent with Carcello et al. (2002). This provides a new empirical finding about the relationship between multiple directorship and audit fee in Malaysia. One interpretation with respect to the positive association between boards' expertise and external audit fee is that more board of directors who hold multiple directorships basically will use their experience to demand more audit scope and purchase high quality of audit, hence resulting in higher external audit fee.

Table 4: Regression results for external audit fee on controlled and internal governance variables (N=115)

Variables		Expected Sign	Coefficients	t-statistics	p-values
HYPOTHESIS VARIABLES (H)	BODINDPER	+	-.409	-.948	.345
	BODXPRTPER	+	.246	1.274	.206
	BODMEET	+	-.013	-.544	.587
	ACINDPER	+	.520	.936	.351
	ACXPRTPER	+	-.425	-1.464	.146*
	ACMEET	+	.009	.214	.831
CONTROLLED VARIABLES (CV)	LNASSET	+	.218	5.715	.000***
	INVRECTA	+	.055	.240	.810
	SQSUBS	+	.327	11.625	.000***
	BIG4	+	.000	.003	.998
REGRESSION SUMMARY	R^2 Adjusted R^2 F		.701 .673 24.420		 .000***

*Note: ***/**/* are significant at 1%/5%/10% level respectively (1-tailed).*

Regression results of the association between external audit fees and controlled variables

The results of the models are consistent with previous studies with respect to the controlled variables. Auditee size (measured by natural log of asset) and auditee complexity (measured by square root of subsidiaries) have a significant and positive impact on audit fee (Simunic, 1980; Chan et al., 1993; Che Ahmad and Derashid, 1996; O'Sullivan, 2000). As expected, these results show that larger and more complex companies require more extensive auditing, resulting in a higher audit fee.

As for the audit risk, the result of this study inconsistent with O'Sullivan (2000) and Carcello et al. (2002) which find positive and significant result to support the proposition that the proportion of assets in receivables and inventories influences the level of audit fee. Theoretically, companies with large amounts of assets are exposed to high audit risk since the valuation of receivables and inventories is subject to doubtful debts and obsolescence respectively. The INVRECTA (measure for audit risk) shows insignificant result and this could be due to the sampling limitation of small sample size of the study.

Then, the type of auditor as represented by Big 4 and non-Big 4 firms for this study indicate that this controlled variable is not significantly associated with higher audit fee. This suggests that there is no Big 4 audit firm premium in Malaysia which is consistent with other studies in Malaysia (e.g Simon et al., 1992 and Rose, 1999) but this result could also be due to the lack of variation in this variable.

Regression Diagnostic

A number of diagnostics on the regression have been performed including examining on the multicollinearity, heteroscedasticity, outliers and normality assumption. In terms of multicollinearity, two sets of tests were carried out. First, variance inflation factor (VIF) score was used to test the multicollinearity and the results reveal no problems with multicollinearity since all score are less than 2. Second, per Besley et al. (1980), the condition indices were calculated. The results reveal that the condition indexes are range from 1 to 73.916. According to Besley et al. (1980), a condition index of 5-10

indicates weak dependencies and a condition index of 30-100 indicates moderate-to-strong relations among the independent variable. However, when identifying each condition index of moderate-to-strong (32.398 and 73.916), there is no the proportion variance (0.9 or more) for two or more coefficients. Therefore, it appears that multicollinearity is not a serious problem. With respect to heteroscedasticity, the White test was performed which failed to reject the null of homoscedasticity, suggesting that heteroscedasticity has not interfered with the OLS regressions. As testing for the outlier, the study found there is no problem with the outliers. Finally, plotting the residuals suggest a normal distribution. Therefore, it appears that the assumptions underlying OLS regression have been satisfied.

CONCLUSIONS

Generally, the results reveal that these governance structures are not significant to external audit fee except for audit committee expertise. The finding for audit committees' expertise reveals that there is negative association between audit committee expertise and external audit fee. This specifies that more audit committee members who possess accounting professional certification tend to affect lower external audit fees. It implies more audit committee expertise would provide a complementary effect towards audit effort since they could detect, know and understanding better about various issues in accounting and auditing which could lead to the reduction of auditors' risk assessments associated with the financial reporting process as posited by Yatim et al. (2006), Wan Adibah and Khairul Anuar (2012) and Nurul Azlin et al. (2013), thus resulting in lower external audit fee.

While the study makes partly contribution to the audit fee determination in Malaysia, the findings of this study are subject to several limitations. The sample size applied in this study consisting only 115 companies from Main Market listed in the Bursa Malaysia. Therefore, the results may not be generalized or should be interpreted with caution.

There are a number of opportunities for future research. This study examined only two types of variables (board characteristic and audit committee characteristic) for corporate governance structure. Other variables such as director's remuneration or ownership structure and audit tenure could be included in the model in order to examine whether the independence of board and independence of auditor respectively will impact the audit fee determination. Also, the present of other governance mechanism in identifying risk assessment can be interesting part to study this relationship with audit fee determination. Further, alternative research methods such as interviews or surveys could be conducted in order to further investigate the impact of this governance structure on external audit fee paid. Finally, through this interview or survey, it is also suggested to include audit hour for future study in order to assess this variable on external audit fee as Malaysia Institute of Accountant By-Laws (On Professional Conduct and ethics) (2002) has stipulated to determine audit fee based on the time spent by auditor.

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