INTERNAL GOVERNANCE MECHANISMS AND AUDIT FEES: THE MODERATING ROLE OF POLITICAL CONNECTION AND REGULATORY OVERSIGHT

NORZIATON ISMAIL KHAN

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FACULTY OF BUSINESS AND ACCOUNTANCY
UNIVERSITY OF MALAYA
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Abstract

This study has four (4) broad objectives. The first objective is to investigate whether politically connected (PCON) firms pay higher audit fees than non-PCON firms. The second objective is to examine the moderating effect of political connections (PCON versus non-PCON) on the association between the internal governance mechanisms, specifically, audit committee (AC) and internal audit functions (IAF), and audit fees. The third objective is to investigate whether high regulated firms (HRFs) pay higher audit fees than less regulated firms (LRFs). The fourth objective is to examine the moderating effect of regulatory oversight (HRF versus LRF) on the association between the above mentioned internal governance mechanisms and audit fees.

This study is conducted in the Malaysian corporate setting that is unique due to the high involvement of the government in business (resulting in significantly high political connectedness with businesses) and the stringent regulatory oversight by the Central Bank of Malaysia (Bank Negara Malaysia) on financial institutions. In addition, the Bursa Malaysia revised its Listing Requirements to enhance the internal governance mechanisms in 2008, thus providing an opportunity to examine the audit fees issue from the demand side perspective both for the PCON firms and the HRFs.

This research draws from three theories, namely, the agency theory, political embeddedness perspective and institutional theory, to form the framework and develop the hypotheses to be examined.

Six (6) hypotheses are developed and tested, using data from 209 sample firms from years 2005 to 2009, that are before and after the revision of the Bursa Malaysia Listing Requirements in 2008 (BMLR 2008). The data were collected from the firms' annual reports and *DataStream*. In addition, interviews were conducted with selected external auditors, heads of the internal auditors and regulators that ascertain the existence of the demand side explanation for the audit fees.

This study is important as it provides additional knowledge about the impact of the revised BMLR 2008 on AC characteristics and IAF attributes for PCON firms since most prior research was conducted before 2008. Specifically, it is evidenced that PCON firms have higher audit fees due to improved internal governance mechanisms which demand for increase in audit effort. Further, this study also provides support that HRFs firms have higher audit fees than LRFs due to the existence of an industry-specific regulator, over and above the capital market regulator, which requires more audit effort thus, increase in audit fees. As such, this study provides evidence and implications for regulators and others concerned with establishing guidelines and listing rules pertaining to internal governance mechanisms in an institutional context such as Malaysia.

Abstrak

Kajian ini mempunyai empat (4) objektif umum. Objektif yang pertama adalah untuk menyiasat sama ada firma terkait politik (TKP) membayar yuran audit yang lebih tinggi berbanding dengan firma tak terkait politik (TTKP). Objektif kedua adalah untuk meneliti kesan moderat yang ditunjukkan oleh pertalian politik (TKP lawan TTKP) terhadap perkaitan antara mekanisme-mekanisme tadbir urus dalaman, khususnya jawatankuasa audit (JA) dan jawatankuasa audit dalaman (JAD), dengan yuran audit. Objektif ketiga adalah untuk menyiasat sama ada firma yang amat dikawal (FAD) membayar yuran audit yang lebih tinggi berbanding dengan firma yang kurang dikawal (FKD). Objektif keempat adalah untuk meneliti kesan moderat yang ditunjukkan oleh pemerhatian kawal selia (FAD lawan FKD) terhadap perkaitan antara mekanisme-mekanisme tadbir urus dalaman yang disebutkan tadi dengan yuran audit.

Kajian ini dijalankan dalam persekitaran korporat di Malaysia yang tersendiri hasil daripada penglibatan aktif oleh pihak kerajaan dalam perniagaan (yang menyebabkan keberkaitan politik yang tinggi dalam pelbagai perniagaan) dan pemerhatian kawal selia yang ketat oleh Bank Negara Malaysia ke atas institutі-institusi kewangan. Tambahan lagi, pada tahun 2008, Bursa Malaysia menyemak semula Keperluan Penyenaraian untuk mempertingkatkan mekanisme tadbir urus dalaman, lalu membuka ruang untuk meneliti isu yuran audit dari perspektif sudut permintaan bagi firma TKP and FAD.

Kajian ini bertitik tolak daripada tiga teori, iaitu teori agensi, teori perspektif ketersiratan politik, dan teori institusi untuk membentuk rangka kerja dan membangunkan hipotesis untuk diteliti.

Enam (6) hipotesis dibina dan diuji dengan menggunakan data daripada 209 firma sampel daripada tahun 2005 hingga 2009, iaitu sebelum dan selepas semakan semula terhadap Keperluan Penyenaraian Bursa Malaysia pada tahun 2008 (KPBM 2008). Data dikumpul daripada laporan tahunan firma dan *DataStream*. Lebih lanjut lagi, temuduga dijalankan dengan auditor luar, ketua auditor dalaman, dan pengawal selia terpilih yang mengesahkan wujudnya penjelasan tentang sudut permintaan bagi yuran audit tersebut.

Kajian ini penting kerana ia memberi pengetahuan tambahan berkenaan kesan semakan semula KPBM 2008 terhadap ciri-ciri JA dan sifat-sifat JAD terhadap firma TKP memandangkan kebanyakan kajian yang lebih awal dijalankan sebelum tahun 2008 lagi. Lebih khusus lagi, ia membuktikan bahawa firma TKP dikenakan yuran audit yang lebih tinggi yang disebabkan oleh penambah-baikan mekanisme tadbir urus dalam yang memerlukan usaha mengaudit yang lebih mendalam. Selanjutnya, kajian ini juga menyokong bahawa firma TKP dikenakan yuran audit yang lebih tinggi berbanding TTKP kerana wujudnya pengawal selia yang khusus bagi sesuatu industri, di samping pengawal selia pasaran modal, yang memerlukan usaha pengauditan yang lebih mendalam yang menyebabkan meningkatnya yuran audit. Oleh yang demikian, kajian ini memberi bukti dan implikasi kepada pengawal selia dan mereka yang berkaitan dengan mengeluarkan garis panduan dan peraturan penyenaraian yang berkaitan dengan mekanisme tadbir urus dalaman dalam konteks institusi seperti di Malaysia.

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This thesis is dedicated to my husband, Fazil Baharuddin for his love, patience, encouragement and prayers. To my late mother, Halimah Zakaria, my father, Ismail Khan, my son, Naqib Mikhael and daughter, Farrah Sofea, and other important family members, for their patience and moral support.

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AC	Audit Committee
AICPA	American Institute of Certified Public Accountants
AOB	Audit Oversight Board
AS	Auditing Standards
ASX	Australian Stock Exchange
BAFIA	Bank and Financial Institution Act
BIS	Bank for International Settlement
Big4	Big Four
BMLR	Bursa Malaysia Listing Requirements
BM	Bursa Malaysia
BNM	Bank Negara Malaysia
BRC	Blue Ribbon Committee
CCM	Companies Commission of Malaysia
CBO	Central Bank of Malaysia Ordinance 1958
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CMSA	Capital Markets and Services Act 2007
COO	Chief Operating Officer
CPA	Certified Public Accountant
CPAAOB	Certified Public Accountants and Audit Oversight Board
EA	External Auditor
EPF	Employees Provident Fund
FAMILY	Family Ownership Firms
HRFs	High Regulated Firms
IA	Internal Audit
IAF	Internal Audit Functions
IASB	International Accounting Standard Board
ICA	Industrial Coordination Act 1974
IFAC	International Federation of Accountants
IIA	Institute of Internal Auditors

IIAM	Institute of Internal Auditors Malaysia
INST&MGRL	Institutional Ownership Firms and Managerial Ownership Firms
ISA	International Standards of Auditing
LRFs	Less Regulated Firms
LTAT	Lembaga Tabung Angkatan Tentera
LTH	Lembaga Tabung Haji
MAS	Malaysian Airlines System
MASB	Malaysian Accounting Standards Board
MCCG	Malaysian Code on Corporate Governance
MD	Managing Director
MIA	Malaysian Institute of Accountants
MICG	Malaysian Institute of Corporate Governance
MSWG	Minority Shareholders Watchdog Group
NACD	National Association of Corporate Directors
NEP	New Economic Policy
NST	New Straits Times
NYSE	New York Stock Exchange
NZX	New Zealand Exchange
OECD	Organization for Economic Co-operation and Development
PCAOB	Public Company Accounting Oversight Board
PCON	Politically Connected Firms
PNB	Permodalan Nasional Berhad
ROC	Registrar of Companies
ROSC	Reports on Observance of Standards and Codes
SAS	Statements on Auditing Standards
SC	Securities Commission
SCA	Securities Commission Act 1993
SEC	Securities and Exchange Commission
SIC	Statement of Internal Control
SOCSO	Social Security Organization
SOX	Sarbanes-Oxley Act 2002

Chapter 1 INTRODUCTION

1.1 Introduction

This chapter provides an overview of the research study. It discusses the background of this study, followed by the motivation, research objectives and research questions of this study. It briefly explains the research methodology, theoretical framework, hypotheses development and research model. Further, a summary of the research findings is provided, followed by a discussion on the significance of the study. Finally, the chapter narrates the organisation of this thesis.

1.2 Background of Study

Malaysia has made significant progress in developing an efficient and well-regulated capital and financial market, as well as strengthening the institutional framework for the regulation of the accounting and auditing profession (World Bank, 2012). Good progress has been achieved in improving the quality and consistency of corporate financial reporting and corporate governance (CG) for listed firms. The importance of good governance and the need to raise CG standards were recognised since the 1997 Asian financial crisis which highlighted the need for strong CG practices. The Kuala Lumpur Stock Exchange's (now Bursa Malaysia) joint survey[1] with Price Waterhouse Coopers in 1998 found that 94 percent of the surveyed firms agreed that the Malaysia's CG regime required reformation particularly in addressing issues of investors' confidence, minority shareholders protection and transparency in directors' dealings.

[1] KLSE/Price Waterhouse Coopers' survey was to improve corporate governance framework and to ensure firms apply the highest possible standard of 'best practices'.

The World Bank had conducted three (3) assessments on the observance of CG codes in Malaysia since 2001 (World Bank, 2001; 2005 and 2012). In the 2005 Report, it was observed that Malaysia faced several challenges to further improve its corporate governance practices. Amongst these challenges, the government's level of equity ownership had remained large, whilst free float remained low and directors' accountability and protection for minority shareholders were noted to require further improvement. In addition, the role of institutional investors and shareholder activism in the corporate governance framework need to be strengthened (World Bank, 2005).

Following the 2001 and 2005 World Bank Reports, the corporate governance landscape in Malaysia transformed significantly as firms accentuated their corporate governance efforts. For instance, the Bursa Malaysia introduced Corporate Governance Initiatives to raise the standards of corporate governance practices among listed firms, and the minority shareholders watchdog group (MSWG) introduced a Malaysian Corporate Governance Index to promote best practices in CG among listed firms in 2009. This is supported further when Malaysian firms with concentrated ownership produced better accounting results (Haniffa and Hudaib, 2006). Malaysia was also ranked 6th (among 11 Asian countries) in terms of Corporate Governance quality in Corporate Governance Watch 2007[2] (ACGA, 2007) and has improved to rank 4th in 2012 (ACGA, 2012).

In 2007 the Securities Commission (SC) released the revised code of corporate governance to further strengthen Malaysia’s corporate governance framework, aligning it with the then current globally accepted best practices. The Malaysian Code of Corporate Governance

[2] This report was produced in collaboration between the Asian Corporate Governance Association (ACGA) and an independent non-profit organisation in Hong Kong.

(MCCG, Revised 2007), which superseded the earlier Code issued in March 2000, contains recommendations aimed to strengthen the roles and responsibilities of boards of directors and audit committees so as to ensure that they discharge their duties effectively. Subsequently, the newly amended regulations under Section 9 of the Capital Markets and Services Act 2007 (CMSA) and the revamped Bursa Malaysia Listing Requirements (BMLR) in 2008 called for increased interaction between the internal governance mechanisms of audit committee and internal audit function.

The oversight duties of an audit committee as prescribed by the BMLR 2008 include reviewing the audit plan with the external auditor; reviewing the audit report; ensuring the adequacy of the scope, functions and resources of the internal audit function and reviewing the internal audit program. In fulfilling the internal audit oversight function, internal auditors perform analyses and appraisals of activities to make recommendations for improving internal controls and promoting efficiency. Clearly, the interactions amongst these key players are important to achieve effective governance in a firm.

1.2.1 Level of Audit Fees

The World Bank Report on Observance of Standards and Codes (2012) highlights that there is anecdotal evidence that suggests that generally the audit fees charged in Malaysia are low when compared with other ASEAN member countries (World Bank, 2012, p.4). The Report further elaborates that the reasons for this reflect the price-competitive environment in which the audit profession has been operating in and the relatively low salaries paid to accounting professionals in Malaysia (particularly when compared with Singapore). The Report suggests that it is not uncommon for decisions on hiring auditors to be based primarily on the audit fee level. The concern raised by the World Bank is that over time this practice could have a significant impact on audit quality and potentially damage the reputation of the Malaysian audit profession as a whole.

The World Bank team acknowledges that the regulators are aware of this issue, and that the Audit Oversight Board (AOB) has also raised concerns about price-based competition at a time when audit firms are incurring additional costs to meet higher-quality standards. Measures are taken to address the matter. The World Bank report also notes that the regulators are putting significant efforts into providing education to directors and ensuring the governing bodies (particularly audit committees) to properly balance considerations of audit quality with the level of audit fees in appointment decisions. In addition, banks and insurance firms are required to obtain prior approval from Bank Negara Malaysia on an annual basis on the appointment of auditors. Further, the Audit Oversight Board (AOB) is working with other stakeholders in enhancing audit quality, including addressing the issue of audit fees. Its importance is linked to the ability of accounting firms to be able to attract and retain talent and pay competitive remuneration. The World Bank Report issued in February 2012 suggests that a review of the legislation and regulations governing auditors should be conducted with the overarching goal of supporting high-quality audits within a framework of free and open market competition. It is believed that this process is currently ongoing. This study (which focuses on the audit fee phenomenon in Malaysia) is timely in response to the concerns raised by the World Bank Report 2012 regarding the low audit fees in Malaysia.

1.2.2 Supply and Demand Perspectives in Audit Fees

Audit fees may be examined from the supply or demand perspectives. The supply perspective posits that external auditors are able to reduce the external audit testing and consequently audit fees if the internal governance mechanism serves as a substitute to the external auditors in monitoring the management. However, if the external auditors perceive the audited client as having higher audit risks, they are expected to expend more audit effort hence leading to higher audit fees.

On the other hand, the demand perspective holds that if the internal governance mechanism complements the work performed by the external auditors, higher audit fees will be charged to the audit client because the internal governance mechanism will demand more audit procedures from the external auditor in order to avoid material misstatements in financial reporting.

According to Griffin, Lont and Sun (2008), the relations between corporate governance and audit fees can be explained through the demand and supply perspectives. Whereby, (1) there is an increase in audit fees because auditing services provide a mean to attain better governance, and (2) there is a decrease in audit fees due to auditors incorporating the benefits of better governance when pricing their services. Their results suggest that better governance reduces the cost of auditing. This is because better governance enhances the quality of financial statements and internal controls, which reduces the audit risk and consequently audit fees.

1.2.2.1 Political Connections

As observed in the World Bank Report in 2005, the high level of government equity ownership was then seen as a challenge in enhancing good corporate governance in Malaysia. Several corporate governance studies prior to 2007 had investigated the government-linked firms[3], and found firms with political connections to be more risky. Politically connected firms are firms identified as having political connections with key government officials (see Gomez and Jomo, 1999; Johnson and Mitton, 2003; Mohamad, Hassan and Chen, 2006; Abdul Wahab, Mat Zain, James and Haron, 2009) [in this study government-linked firms with political connections are collectively referred to as politically connected firms or PCON firms]. Firms other than PCON firms can be categorised into institutional and managerial (INST&MGRL) ownership structured firms and family-owned (FAMILY) firms. In this current study, they are collectively referred to as non-PCON firms. While, there is consensus in the extant literature that PCON firms differ from other types of ownership structured firms (Faccio, 2010), there is limited empirical evidence on the impact of corporate governance reforms between these two groups.

Malaysian PCON firms are said to be favoured firms (Gomez and Jomo, 1999; Gul, 2006; Johnson and Mitton, 2003), which makes Malaysia an interesting case study. According to Gomez and Jomo (1999), the purpose of having favoured firms is to reduce equity ownership imbalance between the various ethnic groups by increasing Bumiputra[4] equity ownership in the capital market.

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[3] Government-linked firms are defined as firms that have a primary commercial objective and in which the Malaysian Government has a direct controlling stake through Khazanah, Ministry of Finance (MOF), Kumpulan Wang Amanah Pencen (KWAP), and Bank Negara Malaysia (BNM) [Putrajaya Committee GLC (PCG) high performance, (2007)]

[4] Bumiputra means in Malay “sons of the soil”. It refers to Malays and other indigenous people as distinct from Chinese, Indians, and other non-indigenous residents.

Studies conducted prior to MCCG 2007 [Johnson and Mitton, 2003 (study period 1990-1999); Fraser, Zhang and Derasid, 2006 (study period 1990-1999); Faccio, Masulis and McConell, 2006 (study period 1997-2002); Gul, 2006 (study period 1996-1998); Yatim, Kent and Clarkson, 2006 (study period-2003); Abdul Wahab, Mat Zain and James, 2011 (study period 2001-2003); Bliss and Gul, 2012 (study period 2001-2004)] show that PCON firms were perceived by the market and the external auditors to be riskier than non-PCON firms and as such were imposed with higher audit fees. A recent study by Bliss and Gul (2012) shows that PCON firms are perceived as being of higher risk due to higher extend of leverage. Such perceptions in turn are expected to increase monitoring costs leading to higher audit fees.

Further, political connection draws on the concept of political embeddedness[5] which is divided into two strands of benefits and costs. First, it explains a firm's direct ties to the government which provide opportunities to obtain valuable advice and facilitate access to government resources (Okhmatovskiy, 2010). Secondly, the government tends to pursue its own political or socio-economic goals and abuses its power to divert the firm's resources to achieve the government's goals (Shleifer and Vishny, 1998). The government may also promote strategies to maximise its own interests which may diverge from those of the firm and its shareholders. In Malaysia, the issue of PCON firms is more crucial as they are also perceived to be firms favoured by the government.

As PCON firms are generally perceived to exhibit poor corporate governance, greater agency problems (Abdul Wahab *et al.*, 2009), and more risk (Gul, 2006), prior studies had drawn on the supply based perspective in explaining the audit fee phenomenon. However,

[5] Political embeddedness refers to bureaucratic, instrumental, or affective ties to the state and its actors (Michelson, 2007).

given the enhanced CG reforms since 2007, it is timely for a research to explore the explanation from the demand side by investigating the internal governance mechanisms' impact post-BMLR 2008 implementation on audit fees. Furthermore, as the enhanced CG practices were mandated since 2001 [as observed in the World Bank Report (2012)], there is a marked improvement in corporate governance and it is believed that such improvements would have led to the demand side explanation for audit fees to be of greater significance.

Hence, this study examines the moderating effect of political connections on the association between the internal governance mechanisms of audit committee characteristics and internal audit function attributes, and audit fees for PCON firms.

1.2.2.2 Regulatory Oversight

It is also noted that most prior studies on corporate governance have examined only the non-financial firms because financial firms were perceived to be highly regulated. Therefore, this study also investigates the impact of enhanced corporate governance in the highly regulated sector.

Regulatory oversight influences corporate governance practices in organizations in the following ways. Regulatory oversight partially substitutes for corporate governance and reduces the need for extensive external audit testing in highly regulated firms (HRFs) which results in lower audit fees (Dunn and Mayhew, 2004; Bryan and Klein, 2005; Boo and Sharma, 2008). Further, close monitoring by an industry-specific regulator reduces information asymmetries and the level of oversight required from the corporate governance mechanisms such as the boards of directors, audit committees and external auditors (Demsetz and Lehn, 1985; Smith and Watts, 1992; Bryan and Klein, 2005). Hence, lower audit fee was evidenced for highly regulated firms as compared to less regulated firms (LRFs) (Boo and Sharma, 2008).

Bedard, Johnstone and Ettredge (2004) posit that from a governance risk perspective, the external auditors perceive lower client risks if the firm is subjected to a strong regulatory oversight function coupled with having an effective audit committee and internal audit functions. The external auditors will have greater assurance that the internal governance mechanisms are operating effectively, thus the audit effort and fees are reduced.

However, according to Abbott, Parker, Peters and Raghunandan (2003), given the complementary effect of regulatory oversight for internal governance, independent directors serving on the boards of HRFs have greater incentives to protect their reputational capital and avoid litigation cost than those in LRFs. Further, stringent regulatory oversights enhance the critical role of internal governance mechanisms (Stoll, 1998; Adams and Mehran, 2003) and consequently increase in audit fees. In other words, as stricter requirements are imposed on highly regulated firms due to its industry-specific regulator, the boards of directors and audit committees of HRFs may demand for additional assurance from the firms' external auditors. This is because regulatory oversight demands the directors to discharge their governance duties. The risk of lawsuits increases if the directors fail to perform (Boo and Sharma, 2008). As a result, a wider scope of audit engagement by auditors is required causing an increase in the audit fees.

Questions arise as to whether corporate governance reforms can also be effective at enhancing the governance of highly regulated industries, particularly the banking and insurance firms in Malaysia which is strictly regulated by the Bank Negara Malaysia (BNM). This and other differences between highly regulated and less regulated firms have led to the conflicting views on the role of regulatory oversight as a substitute or complement for internal governance of highly regulated firms (Stoll, 1998; Adams and Mehran, 2003). Hence, the existence of the regulatory oversight and audit fees gaps arguably needs to be addressed and investigated so as to offer a better and clearer understanding on corporate governance issues. In addition, as will be discussed below, it is still unclear whether regulatory oversight moderates the relationship between the internal governance mechanisms and audit fees. Therefore, this study examines the moderating effect of regulatory oversight on the association between the said internal governance mechanisms and audit fees for HRFs.

1.3 Research Motivations, Objectives and Research Questions

The motivation for the present study is based on three considerations. First, there have been several studies concerning the internal governance mechanisms of audit committee characteristics and internal audit function attributes associated with higher or lower levels of audit fees. Similarly, there are also studies on the relationship between the said internal governance mechanisms and audit fees stemming from both the demand for audit services by the client (Goodwin and Kent, 2006; Abbott *et al.,* 2003; Yatim *et al.,* 2006; Carcello, Hermanson, Neal and Riley, 2002; Hay, Knechel and Ling, 2008) and the supply of audit services by the external auditor (Collier and Gregory, 1996; Felix, Gramling and Maletta, 2001).

Prior studies on PCON firms have generally drawn on the supply based perspective. Additionally, these studies have also examined the relationships between corporate governance and audit fees for PCON firms before Bursa Malaysia revised its listing requirements in 2008 (for example, Johnson and Mitton, 2003; Gul, 2006; Yatim *et al.*, 2006; Eichenseher, 1995). Further, such studies on auditors also focused on auditor tenure, audit quality, audit risk and audit fees (Redmayne, Bradbury and Cahan, 2011; Ghosh and Moon, 2005; Abdul Wahab *et al.*, 2009; Abdul Wahab, Mat Zain and James, 2011). However, this far no study has examined the audit fee phenomenon subsequent to the enhanced reforms in 2008. It is important to investigate whether the enhanced corporate governance rules impact the PCON and non-PCON firms differently. Therefore, this present research undertake this study to extend the audit fee literature by examining the moderating effect of political embeddedness on the association between the enhanced listing requirements pertaining to internal governance mechanisms and audit fees on PCON firms in Malaysia.

Secondly, there is still mixed findings on the relationship between the internal governance mechanisms of audit committee characteristics and internal audit functions, and audit fees (Goodwin and Kent, 2006). Furthermore, in Malaysia prior studies were conducted when the CG environment was still in its infancy with limited enforcement. Two contrary views are expressed in the literature regarding the relationship between internal governance and audit fees. The first view holds that better internal governance will lead to lower audit fees, whilst the second view claims better internal governance will lead to more auditing effort and thus higher audit fees (Hay e*t al.* 2008). Due to the inconclusive results, this study explores these associations further and suggests that enhanced internal governance mechanisms in politically connected firms will lead to higher audit fees.

Thirdly, there is also a call for research on the association between internal governance mechanisms and audit fees of firms in highly regulated industry (Cohen, Krishnamoorty and Wright, 2004; DeFond and Francis, 2005). Previous studies before the revision in the code of corporate governance and the BMLR in 2007 and 2008 respectively, were conducted on firms subjected to a less-regulated environment (for example Balachandran, 2007; Yatim *et al*., 2006). No study to date has specifically examined the impact of the Malaysian Code of Corporate Governance (MCCG) 2007 and new BMLR 2008 on highly regulated firms and less regulated firms.

The summary of the three key motivations, research objectives and research questions for this study are shown in Table 1.1 on page 14. The detailed research questions are found in Chapter 2, Section 2.10.

Table 1.1: Motivations, Research Objectives and Questions

Motivations	Research Objectives	Research Questions
1. No study to date on the impact of the revised BMLR 2008 regarding the internal governance mechanisms on audit fees for PCON and non-PCON firms.	To investigate whether PCON firms pay higher audit fees than non-PCON firms.	Do PCON firms pay higher audit fees than non-PCON firms?
2. Mixed findings on the association between the internal governance mechanisms and audit fees.	To examine the association between the audit committee (AC) characteristics and internal audit function (IAF) attributes, and audit fees for PCON and non-PCON firms.	Is the association between AC characteristics and IAF attributes, and audit fees stronger post-BMLR 2008 implementation for PCON than non-PCON firms?
3. Limited research on the effect of regulatory oversight on the association between the internal governance mechanisms and audit fees for HRFs.	To investigate whether HRFs pay higher audit fees than LRFs.	Do HRFs pay higher audit fees than LRFs?
	To examine the association between the AC characteristics and IAF attributes, and audit fees for HRFs and LRFs.	Is the association between AC characteristics and IAF attributes, and audit fees stronger post-BMLR 2008 implementation for HRFs than LRFs?

1.4 Research Methodology, Theoretical Framework, Hypotheses Development and Research Model

This study applies a positivist research methodology that requires a quantitative research approach for data collection and analysis (Chua, 1986). A total of 209 firms observations from 2005 until 2009 are obtained prior to and post-BMLR 2008. The data is collected from the annual reports of sampled firms and *DataStream*. Interviews were conducted with selected external auditors, heads of the internal auditors and regulators to elicit their perceptions and to obtain a better understanding on the enhanced corporate governance, auditing process and their implications on audit fees and this is discussed in Chapter 6.

The four research questions as tabulated in Table 1.1 are guided by three theories, namely the agency theory, political embeddedness perspective and institutional theory, to form the framework and to develop the hypotheses to be examined. The agency theory advocates that the presence of an effective board of directors can increase the credibility of the financial reporting process and facilitate communication between managers, external auditors and internal auditors (DeZoort, 1997). Thus, effective audit committee characteristics will improve the corporate governance practices and higher audit fees due to the demand for additional assurance from the external auditors in order to safeguard their reputational capital (Abbott, Parker, Peters and Raghunandan, 2003). As discussed above, the BMLR 2008 in Malaysia has strengthened the role of the audit committee and mandated the internal audit function of listed firms, lending support to the importance of the agency theory in corporate governance.

Further, there is increasing research that draws on the concept of political embeddedness capturing “bureaucratic, instrumental, or affective ties to the state and its actors”

(Michelson, 2007, p.352, as cited in Okhmatovskiy, 2010). Two strands of research emerge.

The first strand focuses on the benefits associated with political connections, emphasising that such connections provide opportunities on regulatory policies to enhance firms' legitimacy, gain access to valuable state controlled resources, benefit from preferential treatment and also receive exclusive information regarding state policies (Okhmatovskiy, 2010). In this context, such connections may enhance the firms' performance (Luo and Chen, 1997; Peng and Luo, 2000; Fisman, 2001; Johnson and Mitton, 2003; Siegel, 2007).

The second strand, however, posits that such political ties do not necessarily have positive effects on performance as such ties also entail significant costs (Portes and Sensenbrenner, 1993). Arguably, such connections are a source of inefficiencies as the state may pursue its own political or socio-economic goals and may use its control to divert such firms' resources to achieve these goals (Shleifer and Vishny, 1998). In addition, Aharoni (2000) argues that such firms lack monitoring and lack incentives for managers to perform better. Whilst there is consensus in the extant literature that PCON firms differ from non-PCON firms in terms of market and auditor perceptions of risk and performance (Faccio, 2010), there is limited empirical evidence on the impact of corporate governance reforms between these two groups and its association with audit fees.

Besides that, the personal and professional relationships (Richard, 2006) between the external auditors and their former colleagues who are now holding positions in the boards of directors and top management of the audited clients create a situation of high political embeddedness. As former external auditors, the said directors and managers have a better understanding on the tasks carried out by the external auditors and empathise with the low level of audit fees in Malaysia. Further, in order to protect their reputational capital, they will demand for substantive audit procedures and are willing to pay higher audit fees to the external auditors.

In this study, it is found that a higher percentage of PCON firms engaged Big4 auditors to carry out the external audit functions (see Chapter 3, Section 3.2.2). In addition, the majority of the audit committee members of PCON firms are former auditors working in the Big4 audit firms. This leads to another situation of political embeddedness complicating the PCON firms.

In addition, the underlying assumption on the role of regulators in promoting good corporate governance practices is supported by the institutional theory. It is the responsibility of the regulatory agencies having oversight authority over accounting matters (Baker, Nelson and Staley, 2006) to restore public confidence by enforcing corporate governance practices. Thus, the institutional theory theorised an important role for regulatory agencies to ensure that formal mechanisms are in place to ensure compliance of rules and regulations. Using the argument that the role of governance mechanisms is to communicate with the various actors of the corporate governance mosaic (Cohen *et al.*, 2004), this study hypothesised that regulatory oversight strengthens the association between internal governance mechanisms and audit fees in Malaysia. The role of regulatory oversight is more pertinent in highly regulated firms which are financial institutions tightly regulated by the Bank Negara Malaysia.

The hypotheses for this study are divided into two parts as shown in Table 1.2. First, it is to examine the moderating effect of political connections on the association between audit committee characteristics and internal audit function attributes, and audit fees. The variables for audit committee characteristics are independence, diligence and expertise. While the internal audit function attributes are proxied by objectivity and work performance. This research adopts SAS No. 65, *the Auditor's Consideration of the Internal Audit Function of Financial Statements*[6] (AICPA, 1997), to measure objectivity and work performance. The voluntary disclosures on internal audit function activities as per Para 43 of the *Statement of Internal Control* (SIC) are used as a measurement for work performance.

Secondly, it is to examine the moderating effect of regulatory oversight on the association between the internal governance mechanisms of audit committee characteristics and internal audit function attributes and audit fees.

The audit fees models for this study are drawn from prior literature (i.e. Craswell and Francis, 1999; Tsui, Janggi and Gul, 2001; Carcello *et al*., 2002). Model 1 focuses on the moderating effect of political connections on the association between audit committee characteristics and internal audit function attributes, and audit fees (PCON versus non-PCON firms). Model 2 examines the moderating effects of regulatory oversight on the association between the said internal governance mechanisms and audit fees (HRFs versus LRFs). Statistical analyses for Model 1 and 2 are based on the t-tests and Chi-square analysis. A multivariate regression analysis is used to examine both models.

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[6] SAS 65 is similar to ISA 610 adopted in Malaysia. Refer to Chapter 5 Sections 5.6.2 on the International Standard on Auditing (ISA) 610 (Malaysian Institute of Accountants, Internal Auditing Guidelines).

Table 1.2: Summary of Hypotheses

Independent Variables		Hypotheses
		Political Embeddedness
1) Audit Committee Characteristics: a. Independence b. Diligence c. Expertise	H1	PCON firms pay higher audit fees than non-PCON firms.
	H2	The association between audit committee characteristics and audit fees is stronger post-BMLR 2008 implementation for PCON than non-PCON firms**.**
2) Internal Audit Function Attributes: a. Objectivity b. Work Performance	H3	The association between internal audit function attributes and audit fees is stronger post-BMLR 2008 implementation for PCON than non-PCON firms.
		Regulatory Oversight
1) Audit Committee Characteristics: a. Independence b. Diligence c. Expertise	H4	Highly regulated firms pay higher audit fees than less regulated firms.
	H5	The association between audit committee characteristics and audit fees is stronger post-BMLR 2008 implementation for HRFs than LRFs.
2) Internal Audit Function Attributes: a. Objectivity b. Work Performance	H6	The association between internal audit function attributes and audit fees is stronger post-BMLR 2008 implementation for HRFs than LRFs.

1.5 Findings

The t-tests and Chi-Square analysis indicates that audit fees for PCON firms are higher in comparison with the non-PCON firms. In the linear multivariate analysis, four hypotheses are strongly supported namely audit committee diligence (DIL) and expertise (EXP), and internal audit function objectivity (OBJ) and work performance (WP). The results support that audit committee members who meet frequently are well informed and have the knowledge about financial and auditing issues, demand for substantive audit task and consequently results in higher audit fees for the firm. Further, audit committee members with financial expertise provide additional support for external auditors because it allows the audit committee members to better understand the auditing issues, risks and audit procedures (Abbott *et al.*, 2003). Additionally, the results also confirm that PCON firms' heads of internal auditors report directly to audit committee and disclose more information on internal audit activities under voluntary disclosure as per Para 43 of *Statement of Internal Control* (SIC)[7]. The findings in this study supports Goodwin and Kent (2006) and Hay *et al.* (2008) that internal audit and external audit complements each other within the governance framework.

Further, HRFs experience higher audit fees than LRFs. In the linear multivariate analysis, the results indicate that regulatory oversight strengthens the association between audit committee diligence, expertise and audit fees. Finally, this study finds that regulatory oversight strengthens the association between internal audit objectivity and audit fees. These findings suggest that diligent and expert audit committees demand for additional assurance from their external auditors to ensure effective oversight over financial statement audit as well as to protect their reputational capital (Carcello *et al.*, 2002, Abbott *et al.*, 2003). Further, the findings also indicate that regulatory oversight

[7] Refer Chapter 5 Section 5.6.2 on the voluntary disclosure under Para 43 of Statement of Internal Control (SIC)

strengthens the direct reporting line of the head of internal auditors to audit committee, thus leading to greater audit effort and increased audit fees for HRFs.

1.6 Significance of Study

This study is significant as it has five contributions to extant CG research. First, the study provides empirical evidence for regulators and related stakeholders regarding the impact of the enhanced BMLR in 2008 on the internal governance mechanisms of audit committee and internal audit function, since most prior research was conducted before the revision. It supports the claim in the World Bank Report 2012 that enhanced reforms since 2008 have been effectively implemented. Such information may assist regulators and policy makers in implementing further enhancements recommended in the Malaysian Code of Corporate Governance 2012 and also BMLR 2012. Following this, policy makers should ensure mechanisms are in place as this would be an indicator for determining the level of conformance by the audit committee with the newly amended requirements.

Secondly, this study also evidences that enhanced CG reforms does matter for PCON firms in Malaysia despite the negative perceptions raised during the 1997 crisis and thereafter. Since most of the auditing and accounting studies on corporate governance were very much grounded by agency theory (Cohen, Krishnamoorty and Wright, 2008), the inclusion of political embeddedness perspective in this research is a key contribution to extant literature. It explains the political relationships between PCON firms and the government as well as the political networking between former Big4 auditors appointed by the firms and their external auditors. Whilst negative perceptions existed in the market regarding PCON firms, enhanced CG reforms have made a change to the PCON firms. This was also alluded to in the World Bank Report (2012).

Third, given the absence of corporate governance research in highly regulated environment [see Cohen *et al.*, (2004); Defond and Francis (2005)], the investigation as to how highly regulated firms are impacted by corporate governance practices is timely. The environment resulting from the stringent regulatory role of Bank Negara Malaysia (BNM) on the banking institutions and insurance firms provides a good setting to conduct such study. Most of the studies have shown a positive association between internal governance mechanisms and audit fees for less regulated firms. It is not clear whether this relationship still holds in a highly regulated industry, since regulatory oversight could either diminish or heighten the imperative for monitoring by internal governance mechanisms (Boo and Sharma, 2008). Hence, the study confirms the importance of regulatory oversight in enhancing CG effectiveness.

Fourthly, the findings of past research on the relationships between internal governance mechanisms and external auditing as substitutes or complements have been mixed. This study is undertaken to find the role of internal governance mechanisms vis-a-vis external auditing in Malaysia i.e. whether they are substitutes of or complements with each other.

Lastly, given the limited attention on the formulation of an appropriate measure of internal audit work performance, this study extends current literature by introducing new measurement for the work performance of internal audit functions. Since previous measures used for obtaining contribution of IAF relate more to the size of the function rather than the quality (Prawitt, Sharp and Wood, 2008), this research uses SAS No. 65, *the Auditor's Consideration of the Internal Audit Function of Financial Statements* (AICPA, 1997) which describes IAF quality characteristics as comprised of competence, objectivity and quality of work performance. It is important to note that in this study, the voluntary disclosures on internal audit function activities as per Para 43 of the Statement of Internal Control is introduced as the measurement for work performance.

1.7 Organisation of Thesis

This thesis is organised into eight chapters including this introduction chapter. The discussion is organised as follows:

Chapter 1 provides the introduction, background, research objectives and research questions that act as foundation to the whole thesis.

Chapter 2 discusses the extant corporate governance landscape with a focus on the audit fees research. The aim is to articulate the gap in audit fees research and justify the research questions for the study.

Chapter 3 of this thesis explains the agency theory, political embeddedness perspective and institutional theory and how these theories provide the underlying reasons for the relationship between internal governance mechanisms, regulators and audit fees.

Chapter 4 presents the research models and develops the hypotheses for further examination. In specific, six hypotheses are developed for the study. The hypotheses are divided into two sub-sections, under PCON firms and non-PCON firms, and highly regulated and less regulated firms. It draws upon the past literature and the theories examined in Chapters 2 and 3.

Chapter 5 outlines the method of data collection, the definition and reasons for variable selection and the instruments used in measuring the variables. Basically, it explains the research design and the methodology applied in the study.

Chapter 6 analyse of the interviews with selected regulators, heads of internal auditors and external auditors on their perception regarding the audit fees issue.

Chapter 7 discusses the results of the quantitative analysis on the association between internal governance mechanisms and audit fees for the different types of ownership structured firms by focusing on PCON firms. Further, the association between internal governance mechanism and audit fees for HRFs and LRFs are also discussed in this chapter.

Chapter 8 presents an overview of this study and the discussion of the results. Further, contributions and detailed discussions on the limitations of the current study as well as suggestions for future research are also undertaken in this chapter.

1.8 Conclusion

This study extends the inductive research which investigates (1) the moderating effect of political connections on the association between the internal governance mechanisms of audit committee and internal audit function for (PCON versus non-PCON firms) post-BMLR 2008; and (2) the moderating effect of regulatory oversight on the association between the said internal governance mechanisms and audit fees for (HRFs versus LRFs) post-BMLR 2008.

Given the importance of audit quality and regulatory oversight, the issue of audit fees is an important area for investigation in the context of Malaysia as discussed above. Further detailed discussions are in the ensuing chapters. The next Chapter discusses the audit fees literature in more detail and provides the justification for the derivation of the research questions addressed in this study.

Chapter 2 AUDIT FEES AND CORPORATE GOVERNANCE: A REVIEWAND SYNTESIS OF LITERATURE

2.1 Introduction

This Chapter discusses the extant literature on corporate governance and its development with particular focus on studies conducted on audit fees in developed and emerging economies. It then draws an overview of the theoretical linkages among three (3) key organizational monitoring mechanisms namely, audit committee, internal audit function and external audit. It also identifies the research gaps in this area.

2.2 Corporate Governance

'Corporate governance' (CG) is a broad and somewhat vague term used for a range of corporate controls and accountability mechanisms designed to meet the aims of corporate stakeholders. The Cadbury Report (1992) in the United Kingdom (UK) defines corporate governance as the systems by which firms are directed and controlled. The Organization for Economic Cooperation and Development (OECD) principles of corporate governance (1999, revised 2004) took a broader perspective describing corporate governance as a set of relationships between a firm's board, its shareholders and stakeholders.

A definition by the High Level Finance Committee on Corporate Governance in Malaysia in its Report on Corporate Governance (1999, p.52) stated that:

> *Corporate governance is the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking account of the interests of other stakeholders….*

The definitions illustrate that corporate governance is concerned with the firm's internal controls and board structure, as well as external aspects such as its relationship with shareholders and stakeholders. This is in line with the agency theory on the incentives that will align the interests of agents with those of the principals, so the managers of the organization will manage the company in accordance with the objectives of shareholders and at the same time reduce agency costs. As such, corporate governance is a mechanism to facilitate the control of managers and groups of power in the firm and also to facilitate the maximization of firm value (Cuervo, 2002). The exercise of power must be within an accepted governance framework. The board and managers are responsible with directing and managing the business of their firm and as decision makers, they are accountable to the owners of the firm.

2.3 Corporate Governance Landscape

Figure 2.1 shows the evolution of the corporate governance landscape in Malaysia. It can be said that the initiative started with the establishment of the High Level Finance Committee on Corporate Governance in 1999 that consists of members from both government and industry. The Malaysian Code on Corporate Governance (MCCG) which was released by the Committee in March 2000 formed the basis for Corporate Governance Best Practices in 2000. It was initially drawn up to allow for a more flexible approach to raise standards in corporate governance as opposed to the rigid and prescriptive ways imposed by regulations (Arens, Elder, Beasley, Devi, Takiah and Shaari, 2003). The principles underlying the Code focus on four areas namely, board of directors, director's remuneration, shareholders, and accountability and audit.

Figure 2.1: The Corporate Governance Landscape

The Corporate Governance Landscape from 1999 until 2012

1999	2000	2001	2007	2008	2009	2011	2012
High Level Finance Committee on Corporate Governance	Malaysian Code of Corporate Governance (MCCG)	KLSE Listing Requirements	MCCG (Revised)	Bursa Malaysia Listing Requirements (BMLR) 2008	Corporate Governance Guide towards Boardroom Excellence	Capital Market Master Plan 2	MCCG (Revised)
	Minority Shareholders Watchdog Group (MSWG)	Development Financial Institutions Act	Companies Act 1965 (amended)			Corporate Governance Blueprint	BMLR 2012
		Capital Market Master Plan	Capital Markets and Services Act (CMSA) 2007				

Compiled from the following sources:-
Corporate Governance Blue Print (2011), retrieved on 10 March, 2012 from http://www.sc.com.my/.
MCCG (Malaysian Code of Corporate Governance) (2012, 2007 and 2000), retrieved on 7 May 2011 from http://www.sc.com.my/
SC (Securities Commission Malaysia), retrieved on 5 November, 2011 from http://www.sc.com.my/.
MSWG, retrieved on 10 December, 2011 from http://www.mswg.org.my/.
BMSB (Bursa Malaysia Sdn Bhd, formerly known as KLSE) (2001), retrieved on November 4, 2011 from http://www.bursamalaysia.com/.

The corporate governance framework in Malaysia adopts a hybrid approach (Khadaroo and Shaikh, 2007) i.e. a mixture of prescriptive and non-prescriptive approaches. The prescriptive approach is based on regulations, for example, the corporate governance practices in the United States (US) that are heavily regulated by the Sarbanes Oxley Act 2002; and the non-prescriptive approach is based on voluntary codes like those in the United Kingdom (UK) that draw from the Cadbury, Greenbury, Turnbull and Higgs reports.

The combination of these two approaches has contributed to the uniqueness of the corporate environment in Malaysia. Firms should apply the broad principles of good corporate governance set out by the MCCG flexibly and with common sense to the varying circumstances of individual firms. In addition, Bursa Malaysia revamped its Listing Requirements in the year 2001, among others was that all listed firms were required to include a 'Corporate Governance Statement' in their annual reports and disclose their level of compliance with the Code.

In the year 2007, the Securities Commission (SC) released a revised Malaysian Code of Corporate Governance (MCCG, 2007) to further improve the Malaysia's corporate governance framework. The Revised Code of best practices 2007 intended to intensify the roles and responsibilities of the board of directors and audit committee and to ensure that they perform their responsibilities effectively (MCCG, 2007). In 2012, the MCCG 2007 was again revised.[8] Besides that, the newly amended regulations under Section 9 of the Capital Markets and Services Act 2007 (CMSA) and the revamped Bursa Malaysia Listing Requirements (BMLR) in 2008 called for increased interaction between the audit committee and internal audit function.

[8]The new MCCG is taking effect on Dec 31, 2012. The Corporate Governance Blueprint 2011 contains 35 new recommendations for strategic initiatives aimed at strengthening self and market discipline.

In addition, shareholder activism is also on the rise in Malaysia due to the establishment of minority shareholders watchdog group (MSWG) in 2007. This will in the long term positively influence firms (The Star, July 8, 2009). Active shareholders can influence the firm's behaviour such as by alleviating boardroom complacency and bringing about more positive changes in a timelier manner. Further, the Corporate Governance Blue Print was launched in 2011 to provide action plans to raise the standards of corporate governance in Malaysia by strengthening self and market discipline and promoting greater culture of corporate governance. Thus, it can be concluded that this is part of the government's efforts to make Malaysia a more conducive investment arena for investors.

The next section will discuss the corporate governance mechanisms which are divided into three categories, as shown in Figure 2.2. The categories are (1) the internal governance mechanisms; (2) the external governance mechanisms; and (3) the regulatory oversight mechanisms. The interactions among these corporate governance key players are important in order to achieve effective governance in a firm. The interrelationships between various actors and mechanisms within corporate governance are shown in Figure 2.2.

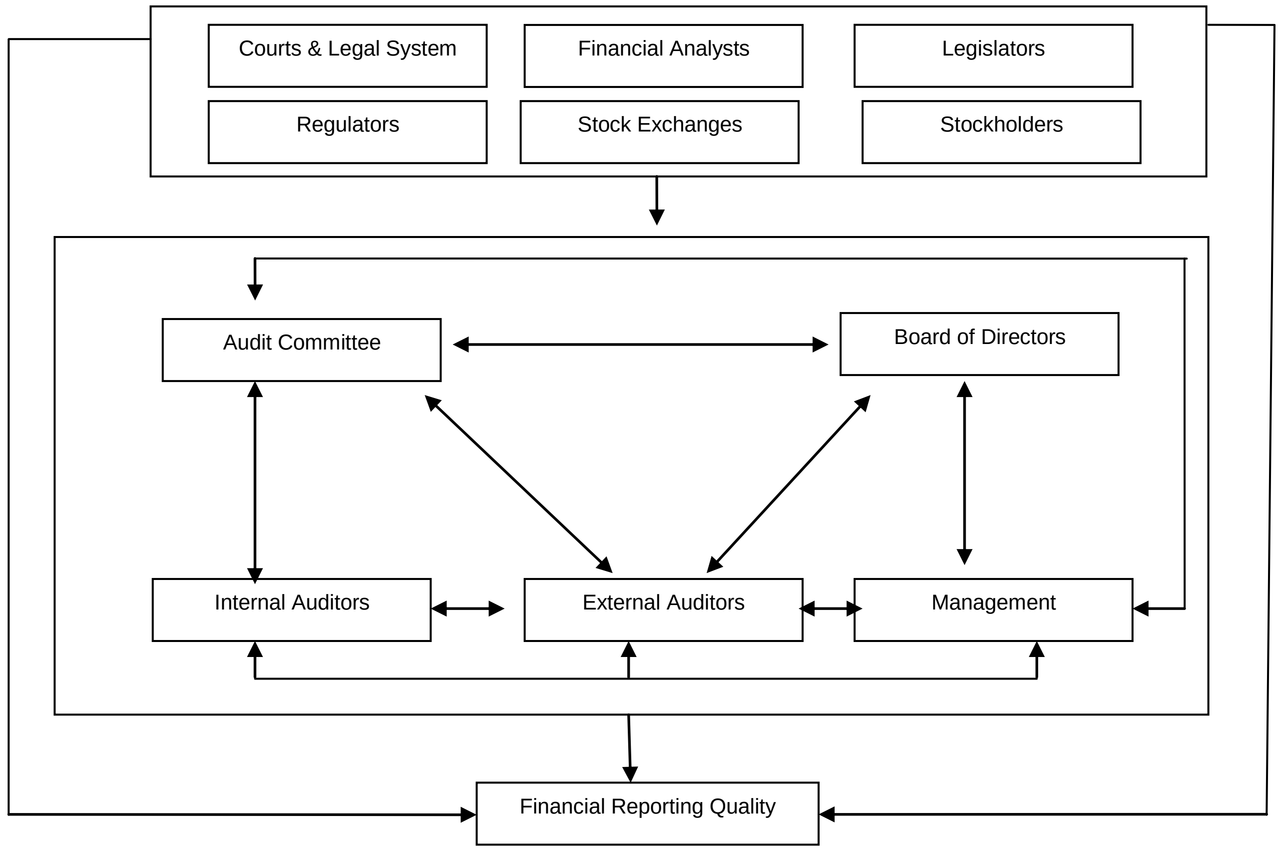

Figure 2.2: Corporate Governance Mosaic and Financial Reporting Quality
Source: Cohen, Krishnamoorty and Wright, (2004)

2.3.1 Internal Governance Mechanisms

The internal governance mechanisms include the board, audit committee, internal auditors and management. With regards to the board and audit committee, prior researches suggest that a stronger board and audit committee are associated with a demand for higher quality audits. Further, stronger internal governance structure should be connected with higher audit fees. According to Carcello *et al*. (2002), high quality board would demand for more external monitoring from external auditors. Abbott *et al.* (2003) posit that from the point of view of the audit committee, they demand a higher level of audit assurance, resulting in an increased level of audit coverage and higher audit fees.

Additionally, a close relationship between the internal auditors and the audit committee has the potential to enhance the corporate governance capabilities of both parties. The independence of the internal auditor firm, from the firm's management is strengthens when it reports directly to the audit committee as required by new Bursa Malaysia Listing Requirements (BMLR 2008). Further, the function of the internal auditor is likely to be enhanced when he is designated as an important agent of the audit committee. Correspondingly, the effectiveness of the audit committee is improved when it is able to obtain significant information on issues of internal controls and quality of accounting policies. Thus, since good governance is human centric and involves corporate governance key players, it stands to reason that audit quality can only be as good as the person providing the service.

Further, the managers must carry out their responsibility and work towards maximizing shareholders' value. Unfortunately, their duties may be impacted by their motivation to maximise their own personal gains. Thus, this type of behaviour needs to be controlled by independent parties who formed the external governance and regulatory oversight mechanisms.

2.3.2 External Governance Mechanisms

The external governance mechanism consists of the external auditors and regulators. As depicted in Figure 2.2, the external auditor plays a significant role in carrying out financial statement audit and hence, can be viewed as an important participant in the governance process. He is a watchdog of the firm, and any shortfall in the performance of his duty will impact investors' protection and confidence. For instance, the failure of an auditor to flag issues of going concern in his opinions will severely compromise the interests of shareholders. Therefore, a public accountant who performs external auditing function is expected to provide reasonable assurance that the management did not distort the true financial performance of the firm (Nazatul, 2009), thus safeguarding the interests of the investing public.

2.3.3 Regulatory Oversight Mechanisms

As shown in Figure 2.2, the regulatory oversight mechanisms comprised of the courts and legal system, regulators, financial analysts, stock exchanges, legislators and stockholders, which are external to the firm. They influence governance in ways that are integral to safeguarding the interests of the firm's stakeholders. These external players often influence the interactions among the actors who are more directly involved in the governance of the firm. Greater regulatory oversight would enhance the critical role of corporate governance. For instance, the impact of PCAOB Auditing Standard 5 on audit fees results from new audit requirements on financial reporting have led to tighten audit regulation. Due to this reason, additional audit work needs to be carried out by external auditors, thus they demand higher audit fees (Jiang and Wu, 2009).

2.4 Corporate Governance and the Audit Profession

The role of an external auditor, who is appointed by the shareholders, is crucial to the effective governance of modern corporations. The Cadbury Report (1992, p.36) stated that:

> *The annual audit is one of the cornerstones of corporate governance. Given the separation of ownership from management, the directors are required to report on their stewardship by means of the annual report and financial statements sent to the shareholders. The audit provides an external and objective* ***check*** *on the way in which the financial statements have been prepared and presented, and it is an essential part of the checks and balances required. The question is not whether there should be an audit, but how to ensure its* ***objectivity*** *and* ***effectiveness.***

Using agency theory, Adams, Sherris and Hossain (1997) posit that the cost of external audit will be determined by the monitoring costs of the auditor, which in turn reflects the internal governance mechanisms and board structure of the firm.

Issues of governance in corporations have become central to the public policy agenda. This has been reinforced by the shocking corporate scandals exhibited by renowned conglomerates such as Enron in 2001 and WorldCom in 2002 in the United States (US). Malaysia also had its fair share of corporate scandals, such as Malaysian Airlines System (MAS), Tabung Haji, Transmile Group Berhad and Megan Media. All these scandals are arguably manifestations of bad governance and thus, there is a need for better monitoring by regulatory institutions, institutional investors and shareholders' watchdog group in order to inculcate good governance practices in the corporate sector.

The activities of the auditing profession in recent years are considered to be tremendously eventful. There have been many occasions where external auditors have failed in performing their duties to exercise independence and objectivity when reporting the results of their audit findings. For example, the collapse of Enron and WorldCom together with their auditor, Arthur Anderson, in the early 2000s put the audit profession under scrutiny globally. As a consequence of the high level of litigation and criticism against auditors, stricter rules and measures were put in place to enhance independence and audit quality. In addition, corrective actions and radical reforms were undertaken in various countries by accounting bodies, governments and capital market regulators to strengthen audit practice (Leung, Cooper and Robertson, 2004). Key reform activities, among others, were the enactment of the Sarbanes-Oxley Act (SOX) in the US in 2002, the Bouton Report in France in 2002 and the Winter Report in the UK in 2002 (IFAC, 2003).

The provision of 'non-audit services' for audit clients which caused conflicts of interest for external auditors was curbed. Leung *et al*. (2004) observe that accounting firms had diversified by providing a wide range of services and products including, among others, tax planning advice and strategic consulting to their audit clients. As a result, auditors played multiple roles simultaneously as advisors to the managers and also as independent attestators to the shareholders. This raised concerns about auditor independence, and measures were introduced to reduce the conflict of interest.

Further, increasing fraudulent practices and corruption have raised concerns regarding the credibility of the audit profession (Business Times, August 23, 2011). This issue has been raised not only in Malaysia but also in the US and countries in the European continent. Consequently, laws were reformed and new professional standards were pronounced. All these changes and measures posed significant challenges for the auditors in carrying out their audit work (Lee and Azham, 2008). They could have an impact on the pricing of audit services, cause necessary price adjustments and consequently, affect the profitability of audits carried out by external auditors.

2.4.1 Corporate Governance and Audit Fees

Good corporate governance is essential to economic stability and growth in developed and developing economies. Malaysia is dedicated to promote the development of sound corporate governance systems and practices (Abdul Rahman, 2006). Indeed, it can be said that considerable progress has already been achieved. Even in the most advanced economies, there have been signs that some developments in capital market have outpaced the development of corporate governance systems and practice (Abdul Rahman, 2006). In an ever-changing world, this is nothing new as financial policy-makers, supervisors and regulators are always trying to catch up with the evolution of capital markets.

Increasing competition and the recent spate of corporate collapses have renewed attention to the efficacy of audit pricing. The auditing profession has received much criticism for the increase in audit fees (Ciesielski and Weirich, 2006). Since the demise of Arthur Andersen, the costs associated with the much reviled section 404 of Sarbanes Oxley (SOX) Act have made the criticism sharper (Lee and Azham, 2008). The purpose of the SOX Act is to reduce the possibilities of corporate fraud by increasing the stringency of procedures and requirements for financial reporting. Section 404 of the Act mandates all listed firms in the United States to establish internal controls and procedures for financial reporting and document test and maintain those controls and procedures to ensure their effectiveness. Compliance is mandated for financial years ending after 15 November 2004.

Enhanced corporate governance is likely to have an effect on audit fees because improved corporate governance implies that the control environment is more effective (Hay *et al.*, 2008). Further, improving governance through improving the board or the audit committee will lead to more external auditing (Hay, 2012). They may demand for more testing as statutory audit is one of the important corporate governance tools for shareholders to monitor the managers.

Past research also shows that audit fees have implications on audit quality (Hoitash, Markelevich and Barragato, 2007). However, in this study audit fees is used to reflect the audit risk of the audit client. This is because audit risk is a significant factor in determining the extent of audit work and consequently determining the amount of audit fees (Chan *et al*., 1993). Basically, the issues can be viewed from two different perspectives; governance risk and demand based perspectives, as discussed below.

From the governance risk perspective, which is also known or referred to as the supply side perspective, researchers argue that corporate governance is associated with lower audit fees (Bedard *et al.*, 2004). The reason is that external auditors respond to client risks through appropriate audit procedures. Auditors who perceive higher risks will increase their audit effort, resulting in higher audit fees. Conversely, if auditors perceive lower client risks, then audit effort and fees may be reduced. Prior studies (for example, Beasley, 1996; Dechow, Sloan and Wong, 1996; Klein, 2002; Abbott *et al*., 2004; Krishnan and Ye, 2005) observe that the strength of board of directors and audit committee is significantly associated with the quality of internal controls and financial reports. Auditors will have greater assurance about internal controls, compliances and reduced likelihood of material misstatement in financial reports if they perceive a strong and independent board and audit committee. In such cases, the auditors may reduce their audit effort, resulting in lower audit fees.

In contrast, from a demand based perspective, researchers propose that higher quality corporate governance structures demand more external monitoring and thus, firms are willing to pay for higher quality audits. Similarly, directors with greater reputational capital at risk will demand substantive audit testing from external auditor in order to protect their reputational capital and reduce the risk of litigation (O'Sullivan, 1999 and 2000; Carcello *et al.*, 2002; Abbott *et al.*, 2003; Goodwin and Kent, 2006). Supported by Bedard *et al*, (2004), auditors will strategically respond to client risks through appropriate adjustments to the audit procedures. In addition, Fields, Fraser and Wilkins (2004) suggest that strong audit committee's internal monitoring reduces risk inherent in banking institutions that could manifest in audit efficiencies. Thus, auditors who observe higher client risks will increase their audit effort, resulting in higher audit fees. The converse will hold if auditors notice lower client risks.

The legislation under the SOX Act was designed to increase the oversight and regulation of the accounting profession with the goals of strengthening corporate governance and increasing the transparency of financial audits (Cosgrove and Niederjohn, 2008). Ciesielski and Weirich (2006) report that between 2001 and 2004, total audit and audit related fees increased by an average of 103 percent for 496 of the S&P 500 firms. The fees increased by an average of 41 percent in 2004 alone upon the implementation of the Act. Further, Taub (2005) in his survey of 40 Fortune 500 firms in the US highlight that PricewaterhouseCoopers observed an increase in audit fees averaging 134 percent. KPMG's fees raised by an average of 109 percent; Ernst & Young's fees increased on average by 96 percent and Deloitte's fees by 78 percent.

With regards to the banking industry, Janson and Scheiner (2007) find that audit and audit-related fees increased between 2003 and 2004 by an average of 61.3 percent for midsized banks, and by 89.0 percent for similarly sized financial services firms in the non-bank sector in the first year of SOX Act compliance. When large-market-capitalization banks were considered, they found that audit fees increased by an average of 50.7 percent, while large-market capitalization financial services firms witnessed an average increase of 50.1 percent.

In contrast, O'Sullivan (1999) in a study during the post-Cadbury period in the UK finds that there is no evidence that the internal governance mechanism influences audit fees even after the firms altered their internal governance characteristics. The Cadbury report sets out recommendations on the arrangement of firm boards and accounting systems to mitigate corporate governance risks and failures. This is because a potential avenue through which external auditors and audit clients may reduce audit costs is by placing greater reliance on the work undertaken by the internal audit function (Felix *et al.*, 2001; Gramling, 1999). This follows the governance risk perspectives for the internal audit function is one of the key governance mechanisms with responsibilities for evaluating and improving internal controls, risk management and other governance processes within the firm. As such, the internal auditor's work has the potential to cover areas which the external auditor needs to examine during the audit engagement period. This may have fee implications too.

A large body of research has examined the determinants of audit fees over the past 25 years (Hay *et al.*, 2006; Hay, 2012). Unfortunately, research to date examining the relationship between corporate governance and audit fees is limited. Additionally, the preliminary support from these past studies (Tsui, *et al.*, 2001; Carcello *et al.*, 2002) signifies contradictory results as to whether the relationship between corporate governance and audit fees is positive or negative. Measures of governance in published studies include the existence of an audit committee and internal audit function. The literature on each of these measures vis-a-vis audit fees will be examined below.

2.4.2 Audit Committee Characteristics and Audit Fees

Audit committee is an important self-regulatory governance mechanism with significant oversight responsibilities over financial reporting, internal control and audit activities (BRC, 1999; SEC, 1999; United States Congress, 2002). Extant literature has examined audit pricing for listed firms in terms of size, organizational complexity, riskiness and specific characteristics of the audit client including various aspects of internal governance structures (Simunic and Stein, 1996; Carcello *et al.,* 2002; Cohen, Krishnamoorty and Wright, 2002; Goodwin and Kent, 2006). Other audit research has sought to identify the impact of various corporate governance factors on financial reporting and audit quality, and the level of audit fees (Gul and Tsui, 1998; Carcello *et al*., 2002; Abbott *et al*., 2003; Tsui *et al*., 2001). These studies find that stronger corporate governance practice is associated with higher audit fees (Chan, Ezzamel and William, 1993; Collier and Gregory, 1996; O'Sullivan, 1999, 2000; Carcello *et al.*, 2002). This is in conjunction with the demand based perspective whereby independent directors demand additional assurance from external auditors in order to protect their reputational capital.

A review of empirical studies on the relationship between audit committee characteristics and external audit fees shows mixed results. Abbott *et al*. (2003) documented that audit committee independence and financial expertise have significant positive impact on the cost of audit. However, Carcello *et al*. (2002) find that the characteristics of the board of director's independence, diligence and expertise but not the audit committee are positively associated with audit fees. The results from Lifschutz, Jacobi and Feldstein's (2010) study on 60 large public firms on the Tel Aviv 100 Stock Exchange Index show that board independence and audit committee diligence are positively and significantly associated with audit fees. However, Boo and Sharma (2008) observe the association between board/audit committee sizes, independence and audit fees is weaker for highly regulated firms than less regulated firms. They also evidence that regulatory oversight strengthens the association between multiple directorships and audit fees. The reason is that regulatory oversight reduces information asymmetry and at the same time reduces the demand for costly monitoring by external auditor.

Similarly, studies have been done in Malaysia on the effect of audit committee as a governance mechanism on audit fees. Results by Yatim *et al.* (2006) show that external audit fees are positively and significantly associated with board independence, audit committee expertise and the frequency of audit committee meetings. Again, the results are consistent with the demand-side approach for audit services, wherein firms with good corporate governance attributes demand higher audit quality, resulting in higher external audit fees. Balanchandran (2007) evidences the relationship between a firm's internal corporate governance characteristics and audit fees and shows the external auditor perceives higher inherent risk when CEO duality is present. His study also shows that CEO duality is associated with higher audit fees in less regulated firms.

In contrast, studies that focus on corporate governance risk (supply side explanation) find that strong corporate governance is associated with lower audit fees (Bedard *et al.*, 2004). They propose that external auditor considers the quality of monitoring provided by internal governance in assessing risk and audit planning. As a result, greater reliance on the internal controls lowers the risk of financial misreporting and thus, the external auditors are likely to reduce the audit engagement work and the extent of audit tests. Past researches (Beasley, 1996; Klein, 2002; Abbott *et al.*, 2004; Krishnan and Ye, 2005) show that the strength of the board and/or audit committee is significantly associated with the quality of internal controls and financial reports which leads to lower audit engagement and audit fees. Tsui *et al.* (2001) also find evidence that board independence is more effective in monitoring a firm's financial reporting process, which decreases control risk and audit fees. Similarly, Boo and Sharma's (2008) research on bank holding firms, find that with the exception of the audit committee, none of the other corporate governance variables are significantly associated with audit fees. They also observe a negative association between audit committee independence and audit fees.

To ensure that audit committee serves as an effective check on the management of a firm, the Bursa Malaysia Listing Requirements (BMLR) was amended in 2008 to provide for the composition of audit committees, the frequency of meetings and the need for audit committee members to attend continuous training to keep abreast with developments in relevant financial and other related developments. In addition, executive directors are no longer allowed to become members of the audit committee in order to preserve the independence of the committee. Following the recent corporate misdeeds which have underscored the importance of having an effective and independent internal audit function, the BMLR 2008 also requires all listed firms to carry out their own internal audit functions. The reporting line for internal auditors has also been clarified, with the audit committee to be held accountable for ensuring adherence to the scope of internal audit functions.

2.4.3 Internal Audit Function and Audit Fees

Prior studies generally suggest that internal control (for example internal audit function) and external auditing can substitute for each other, so that better internal control will be associated with lower audit fees (Hay *et al.,* 2008). In addition, several other studies argue that better internal control will allow external audit work to be reduced, for instance, control mechanisms in an organization can be substituted one for another (Simunic, 1980), and this could lead to lower audit fees. Prawitt *et al.* (2008) highlight that high quality internal audit function (IAF) results in lower external audit fees as well.

Hogan and Wilkins (2008) observe that audit fees are significantly higher for internal control deficient firms and the fee increment is highest for firms that have most substantial internal control problems. Felix *et al.* (2001) suggest that internal audit contribution to external audit work will reduce audit fees, and they find a significant negative relation. Referring to Simunic (1980, 1984), firms can substitute internal control for external auditing if there is monopoly pricing, or substitute external auditing for internal control when knowledge spill over reduce the cost of external auditing.

In contrast, past research has examined the interaction between internal audit functions and external audit services, and finds them to be complementary. From this demand perspective, improved corporate governance is associated with higher audit fees. Walker and Casterella (2000) find that there is a positive relationship between external audit fees and the presence of an internal audit department. Other studies also find that the expected reduction in audit work does not occur even when auditors are able to rely on internal control (O'Keefe, Simunic and Stein, 1994; Hackenbrack and Knechel, 1997). Hay *et al*. (2008) find that controls, governance and auditing are complements, not substitutes, and an increase in one will lead to an increase in the others. According to Goodwin and Kent (2006), audit fees is positively related to the use of an internal audit function because firms with strong corporate governance practices are likely to engage in greater levels of internal auditing and are also willing to pay for a higher quality of external audit work.

2.4.4 Regulatory Oversight and Audit Fees

In Malaysia, banking institutions and insurance firms are subjected to licensing and regulation by the Bank Negara Malaysia (BNM) apart from being regulated by the Securities Commission (SC) and Bursa Malaysia Listing Requirements (BMLR). Comparatively, other listed firms, for example firms in the manufacturing industries, plantations and trading services, are regulated by the Securities Commission and BMLR only. Thus, banking institutions and insurance firms are said to be highly regulated firms (HRFs) as they are supervised by an industry-specific regulator, i.e. the BNM, whereas the other firms may be referred to as less regulated firms (LRFs).

According to Boo and Sharma (2008), direct monitoring and stringent regulatory oversight by an industry-specific regulator reduces the heightened risk and information asymmetries in highly regulated firms. They evidence the regulatory oversight impact on internal corporate governance and audit fees for a sample of 469 US listed highly regulated and less regulated firms. They find that regulatory oversight influences audit fees and the associations between internal governance and audit fees. They also attribute lower audit fees to highly regulated firms as compared to less regulated firms. Dunn and Mayhew (2004) and Bryan and Klein (2005) in their studies posit that regulatory oversight reduces the need for an extensive external audit in highly regulated firms. This is because firms subject to regulatory oversight have stronger corporate governance practices and will vigilantly monitor their internal controls and financial reporting process as they. Besides that, close monitoring by the industry-specific regulator will reduce the role of external auditing as a control mechanism. Consequently, by relying on the effective external and internal monitoring processes, auditors could reduce the extent of costly testing procedures in highly regulated firms. These observations are consistent with the substitute's perspective, whereby regulatory oversight partially substitutes the external audit as a monitoring mechanism.

On the contrary, Abbott *et al*. (2003) argue that greater regulatory oversight enhances the critical role of corporate governance. The rationale is that an independent and effective board and audit committee of a highly regulated firm have greater incentives to protect their reputational capital than those in a less regulated firm. They demand for additional assurance from the external auditor in order to reduce their personal risks. This in turn will lead to additional audit engagement by the external auditors and at the same time increases audit fees. This is consistent with the notion that regulatory oversight complements the internal governance mechanisms. Thus, it is important to study whether regulatory oversight substitute or complements for external audit monitoring in Malaysia.

2.5 The Research Gap: Corporate Governance, Regulation and Audit Fees

As discussed above, studies show that corporate governance has an effect on audit fees because improved corporate governance implies that the control environment is efficient and effective. Further, high quality audit by external auditor is reflected in higher audit fees. According to Menon and Williams (2001), audit production efficiencies should be reflected in lower fees, while increased audit procedures should trigger higher fees.

However, prior research on corporate governance and audit fees reveal conflicting results as to whether the effect is significantly positive or negative (i.e. Tsui *et al*., 2001; Carcello *et al*., 2002). Further, Hunter and Schmidt (1990) suggest that narrative literature reviews can be misleading and often inconclusive. The varying results could possibly be due to variations in sample size, time period and setting of studies. As a result, different researchers may have reached different conclusions about a set of individual studies.

It is still unclear whether the internal audit function plays a substitution or complementary role to external auditing and thus, its implications on audit fees are inconclusive. Additionally, it is not obvious whether regulatory oversight is able to substitute or complement part of external audit work. Due to these conflicting results, it is vital to extend the existing literature by examining the moderating effect of regulatory oversight on the relationship between audit committee characteristics, internal audit function attributes and audit fees in the lens of the demand based perspective.

Furthermore, given that the prior studies were conducted in more developed market settings (like the US and UK), it is unclear whether different institutional settings in emerging markets will provide similar results. Thus, more research needs to be carried out on this issue in an emerging economy such as Malaysia. Next the political economy of an emerging economy, Malaysia, is discussed.

2.6 Political Economy in Malaysia

Economies with efficient economic policies and stable political systems are a big draw to investors. Countries that have opened themselves to the global markets and that have good legal systems in place attract more capital in the process of globalization (Abdul

Rahman, 2006). However, before investors decide to invest their funds in a particular business, they want to be assured that the business is financially sound and will continue to be so in the foreseeable future (Abdul Rahman, 2006). Investors need to have confidence that the business is well managed and will continue to be profitable.

In the era of globalization and open market, Malaysia is exposed to intense competition from other nations. Malaysia has a unique corporate environment which offers clear identifiable segments of ethnic, and politically connected (PCON) firms (Gul, 2006; Haniffa and Cooke, 2002; Yatim *et al*., 2006) and government linked firms (Najid and Abdul Rahman, 2011). It is also generally accepted that Malaysia has favoured firms as a result of the government's intention to increase Bumiputra equity in the country (Gomez and Jomo, 1999; Gul, 2006). It is done through the implementation of the New Economic Policy (NEP) that was introduced in 1971 with the objective to redistribute wealth equally among the Malaysian Bumiputra and non-Bumiputra (Hensley and White, 1993). In order to achieve the NEP's objective, the government has advanced the Bumiputra businesses, both public and private, by establishing public enterprises and joint public-private firms (Bowie, 1988).

There is a close link between selected large firms or conglomerates and the government of the day. These politically connected firms have exclusive business relationships with the state-owned enterprises and have the ability to access the government's major contracts (Gomez and Jomo, 1999). The analysis in Johnson and Mitton (2003) provides insights that stock returns of politically connected firms were lower in comparison with other Malaysian firms. They observe that politically connected firms suffered the most during the early stages of the Asian financial crisis in 1997 assuming that the government was unable to implement capital controls. However, once capital controls[9] were imposed, the returns of these favoured firms were higher on average (Johnson and Mitton, 2003).

According to Gul (2006), the Malaysian corporate sector is differentiated by the existence of the politically connected firms. His study, based on a sample of 740 firm year observations, finds a greater increase in audit fees for firms with political connections than for non-politically connected firms during the financial crisis. However, there was a decline in audit fees for politically connected firms after the capital controls were implemented by the government. Abdul Wahab *et al.* (2009) examine 390 Malaysian firms for the period of 1999 to 2003 and find a positive relationship between institutional ownership and audit fees. They find that the audit fees are higher for politically connected firms.

The corporate landscape in Malaysia is further redefined through the implementation of the Industrial Coordination Act (ICA) 1974. The Act was enacted to further advance the objective of the NEP, i.e. to increase Bumiputra equity ownership in Malaysian listed firms. It requires all firms listed on the stock exchange with equity over a specific limit, to sell at least 30 percent of their shares to Bumiputra. The 30 percent stakes are usually bought by the government institutional investors or other Bumiputra trust funds on behalf of the Bumiputra. Some of these agencies are the Employees Provident Fund (EPF), Permodalan Nasional Berhad (PNB), Lembaga Tabung Angkatan Tentera (LTAT), Lembaga Tabung Haji (LTH) and Social Security Organization (SOCSO), which are also the top five institutional shareholders in Malaysia (Abdul Wahab *et al.*, 2009). The shares would then be held by these agencies until the Bumiputra businesses are

[9] Government's implementation of capital controls in 1998 was primarily to benefit political-connected firms that were adversely affected by the Asian financial crisis in 1997.

ready to acquire them (Hamid, 2011). The intention is to reduce equity ownership imbalance between the various ethnic groups through increasing Bumiputra equity ownership in the capital market (Gomez and Jomo, 1999).

According to La Porta, Lopez, Shleifer and Vishny (1999), the strong governmental intervention through NEP have impaired the enforcement of law and order because ownership is distributed to certain groups of investors rather than competitively achieved. Whilst the Bumiputra are safeguarded under the umbrella of NEP, non-Bumiputra are left to struggle for their own survival in any feasible way, which includes concentrated shareholdings, cross-shareholdings and pyramiding in their firms (Hamid, 2011).

Interestingly, in the aspects of corporate governance and audit pricing, Yatim *et al*. (2006) find evidence that Bumiputra-controlled firms practice favourable corporate governance than non-Bumiputra firms. This shows that Bumiputra controlled firms practice improved internal corporate governance as compared to their non-Bumiputra counterparts. The findings by Gul (2006) and Abdul Wahab *et al.* (2009 and 2011) on audit fees for politically connected firms and Yatim *et al.* (2006) on the audit fees for Bumiputra-controlled firms were based on the data prior to the implementation of BMLR 2008. Thus, it is important to find whether the findings hold even after the corporate governance reform was carried out in 2008.

2.7 Ownership Structure in Malaysia

The political economy shaped the ownership structure of corporation in Malaysia. The rapid growth of the economy has not diluted the concentrated ownership structure in the Malaysian firms. Malaysia offers clearly identifiable capital segments which are divided into different types of ownership structures. This division can be observed and categorised into politically connected (PCON) firms and non-PCON firms. In this study, non-PCON firms are further divided into institutional ownership firms and managerial ownership firms (INST&MGRL), and family ownership firms (FAMILY). This is to provide a more comprehensive analysis. The classifications of this study's sample firms are further discussed in Section 4.5.1 of Chapter 4.

2.7.1 Politically Connected (PCON) Firms

Faccio *et al.* (2006) in their study on political connections defined a firm as politically connected if at least one of its large block holders (anyone directly or indirectly controlling at least 10% of voting rights) or one of its top directors (e.g., CEO, president, etc) is a government minister or a head of state, or is closely related to a top politician or political party, or is a member of parliament.

Malaysia also has its own unique feature of politically connected firms or favoured firms, given the close link between selected large firms or conglomerates and the government. These politically connected firms have exclusive business relationships with the state-owned enterprises and have the ability to access government's major contracts (Gomez and Jomo, 1999). This is because from a political angle, equitable distribution of corporate wealth is one of the key elements under the national development policy. The government has also given much attention and initiatives to ensure that these favoured firms perform in an effective way and assist the government to improve the economic growth.

Market economists have argued that firms in the hands of the government are inferior in performance compared to firms in private hands (Boycko, Shleifer and Vishny, 1996;

Shleifer and Vishny, 1998; Dewenter and Malatesta, 2001). This argument arises due to their institutional relationship with the government, the market structure in which they operate, or the management systems applied within them (Shleifer and Vishny, 1998). Besides that, these favoured firms have also been criticized for being too risk-averse and lacking sufficient entrepreneurial drive. There have been claims that some of their investments may be politically rather than commercially motivated.

2.7.2 Non-PCON Institutional and Managerial Ownership Firms

Another feature of the Malaysian corporate sector that is also shared amongst the East Asian economies such as Indonesia, Thailand, Singapore and Korea relates to institutional ownership (Sulong and Mat Nor, 2008). Institutional ownership in Malaysia is relatively high and represents approximately 13 percent of the total market capitalization of Bursa Malaysia (Abdul Wahab *et al.*, 2009). The top five institutional investors are Employees Provident Fund (EPF), Permodalan Nasional Berhad (PNB), Lembaga Tabung Angkatan Tentera (LTAT), Lembaga Tabung Haji (LTH) and Social Security Organization (SOCSO) (Abdul Wahab *et al.*, 2009). The institutional investors act as an important force in corporate monitoring to protect minority shareholders' interest. The significant increase in the institutional investors' shareholdings has led to the formation of a large and powerful constituency which plays a significant role in corporate governance (The Star, July 8, 2009). The institutional investors act as an important force in corporate monitoring to protect minority shareholder's interest. Thus, they play a significant role in corporate governance (CG Blueprint, 2011).

Firms with managerial ownership are also common amongst Malaysian listed firms. Claessens, Djankov and Lang (2000) estimate that approximately 85 percent of Malaysian listed firms are owner managed, at the 20% cut-off of control right. Jensen and Meckling (1976) observe that as management ownership increases, their interests are more aligned with that of the owners and thus, the need for intense monitoring by the board decreases. They contend that managerial ownership can assist to reduce agency costs because managers who own large fraction of the firm's shares are responsible for any managerial actions that destroy or create value for the firm. When managers own a smaller portion of shares, they have greater incentives to pursue personal benefits and less incentive to maximize firm value. Consequently, one way to reduce the associated increase in agency costs is to increase the shareholdings of the managers.

2.7.3 Non-PCON Family Ownership Firms

Family controlled firm or family ownership is another common form of business organization. A stream of literature explains that family ownership is central in most countries (Ibrahim and Samad, 2010). Thus, study on the role of family ownership is critical to the understanding of corporate governance practices of the firms in Asia (Claessens and Fan, 2002). Unlike the developed countries such as the UK and the US where dispersed ownership is prevalent, Asian firms have more concentrated ownership where family control is common in both small and established firms (Mak and Kusnadi, 2004). The presence of family (Halim, 2001), government or institutional ownership (Abdullah, 2006, World Bank, 2012) may complicate the implementation of corporate governance systems in Malaysia. Claessens *et al.* (2000) study the separation of ownership and control in nine East Asian corporations (Hong Kong, Indonesia, Japan, South Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand), and find that Malaysia has the third highest concentration of control after Thailand and Indonesia, with 67.2 percent are family controlled at the cut off level of voting rights of 20 percent.

Family ownership is predominant as large shareholders in Malaysia (Zhuang, Edwards and Capulong, 2001). Due to this reason, family businesses have become a significant component of the Malaysian economy.

2.8 Institutional Setting: The Profession and Regulation

Recent corporate scandals and irregularities have led to public pressure to reform business practices and increase regulatory oversight. Dishonesty, greed and cover-ups are not new societal concerns. Efforts have been made by the government for the development of corporate governance in Malaysia through legislative measures (Abdul Rahman, 2006). The concern to improve the prevailing state of corporate governance has contributed to the rapid developments of the regulatory framework. Several regulatory and administrative agencies have impacted corporate governance in Malaysia. These agencies include the Securities Commission (SC), Companies Commission of Malaysia (CCM), Bank Negara Malaysia (BNM), Malaysian Institute of Accountants (MIA), Bursa Malaysia (BM) and Malaysian Accounting Standards Board (MASB), as shown in Figure 2.3. These agencies play pivotal roles in providing stringent oversight of firms and the structure of corporate financial reporting framework in Malaysia. The next discussion elaborates further on each agency and its respective role.

2.8.1 Securities Commission (SC)

The Securities Commission (SC) of Malaysia is the key corporate governance regulator and watchdog. The SC was established under the Securities Commission Act 1993 as a regulatory body for the capital market. Its main function is to regulate all matters pertaining to securities and futures markets and at the same time to ensure enforcement of securities and futures laws (http://www.sc.com.my). As an enforcement agency, it has powers to investigate and take administrative, civil or criminal actions against firms. To complement its enforcement role, the SC identifies and builds up front line regulators, for instance, the Bursa Malaysia, Malaysian Institute of Accountants and Malaysian Accounting Standards Board which give emphasis to the auditor's responsibilities in financial statement reporting. The SC monitors and promotes good corporate governance practices. The role of the SC is evidenced by the revision of the Malaysian Code on Corporate Governance (MCCG) in 2007 and 2012.

Another initiative by the SC is the establishment of the Minority Shareholders Watchdog Group (MSWG). It was formed with the aim of promoting the interests of the minority shareholders. One of MSWG's roles is to create awareness among the minority shareholders of their rights to information from firms. MSWG plays a leading role in creating shareholders' activism which aims at making minority shareholders active participants in the market.

In addition, increasing calls to enhance the credibility of financial reporting in Malaysia have also led to several other key developments in enhancing corporate governance practices by the SC. For instance, in 2010, the Securities Commission Act 1993 was amended. The new Section 31B widens the functions of the SC to include promoting and developing an effective and robust audit oversight framework in Malaysia, promoting confidence in the quality and reliability of audited financial statements and also regulating auditors of listed firms. For the purpose of discharging those functions, the Act was also amended by adding new Section 31C to provide for the establishment of the Audit Oversight Board (AOB), and the appointment of the members of the Board by the SC. Since auditors are a crucial link in the financial reporting value chain, the AOB is intended to enhance confidence in the quality and reliability of audited financial statements of listed firms and public interest entities. It is empowered to carry out regular and rigorous inspections to ensure that auditors of these entities comply with the appropriate standards of auditing.

2.8.2 Companies Commission of Malaysia (CCM)

The Companies Commission of Malaysia (CCM) is a government agency in charge of administering and enforcing the Companies Act 1965 which regulates the formation and operations of all firms incorporated in Malaysia. With regard to corporate financial reporting, the CCM plays a major role since the Act specifically spells out most of the financial reporting requirements for firms in Malaysia. The Ninth Schedule of the Act prescribes all the financial information required to be presented in the annual report. Section 174 outlines the reporting responsibilities of the external auditors in connection with audited financial reports. The auditors are required to conduct audits in accordance with the approved standards on auditing in Malaysia to obtain reasonable assurance about whether the financial statements are free from material misstatement.

2.8.3 Bank Negara Malaysia (BNM)

On 23 October 1958, the Central Bank of Malaya Ordinance 1958 (CBO) was enacted and the Central Bank of Malaysia (Central Bank of Malaya until the formation of Malaysia in 1963) commonly known as the Bank Negara Malaysia (BNM) was established pursuant to the CBO on 24 January 1959. BNM’s functions include maintaining the economic interest of the nation and serves as management to provide appropriate structures for a new financial system in Malaysia.

The BNM is renowned for its pursuit of a high level of regulatory and supervisory standards. Over the past forty years, the BNM has played a pivotal role in the systematic development of the financial infrastructure. As the financial regulatory structure evolved, an umbrella of financial safety nets and prudential regulators was put in place to ensure that the inherent safety and the soundness of the Malaysian financial institutions would promote stability within the financial system (http://www.bnm.gov.my/).

According to Lum and Koh (2004), the BNM is one of the best financial regulators in the ASEAN financial market economies due to its strict interpretation and transparency of its regulatory guidelines. It provides a stringent regulatory oversight on all financial institutions and insurance firms in Malaysia. Part X of the Banking and Financial Institutions Act 1989 (BAFIA) also gives power to the BNM to control and supervise the said firms[10]. In section 69, it provides that BNM has the power to examine, without notice, any books and accounts of a financial institution.

Not only does the BNM has the power to examine the financial institution, sections 40, 55 and 57 of the BAFIA provide that the appointment of an external auditor, director or chief executive officer of any financial institution in Malaysia must first be approved by the BNM. In addition, section 40 empowers the BNM to instruct the external auditor on the scope of the audit and to carry out any examination or procedures. Further, the BNM may require the auditor to submit report and any additional information. Though the auditor is instructed by the BNM, his/her audit fees shall be paid by the audited financial institutions.

Further, in regulating the financial institutions, the BNM is also conferred the power to issue “Guidelines” directed to the said institutions. Some examples of the Guidelines

[10] The insurance Act 1996 also has similar provisions applicable to insurance firms.

issued to date are the Guidelines of Corporate Governance for Licensed Institutions, Guidelines on Financial Reporting for Banking Institutions, Best Practices for Risk Management, Guidelines on Fit and Proper for Key Responsible Persons, and Appointment of External Auditors by Banking Institutions.

In certain aspects, it can be said that BNM is a forerunner in promoting corporate governance in Malaysia. For example, the BNM was the first to initiate the setting up of audit committees in financial institutions in 1985. It regulated that a majority of the committee members should be independent non-executive directors. This requirement was subsequently extended to insurance firms (http://www.bnm.gov.my/) and other firms listed in the Kuala Lumpur Stock Exchange (now Bursa Malaysia). In 1994, the listing requirements made it mandatory for every firm seeking listing on the Exchange to form an audit committee comprising of members that are independent of the firm's management. This requirement was imposed to improve investors' confidence and corporate governance in the capital market.

Further, realising the important role played by the internal auditors in the establishment and maintenance of the best possible internal control environment at the firms, the BNM required the establishment of the internal audit functions in financial institutions and insurance firms to support the audit committees in fulfilling their responsibilities.

To promote the independence and objectivity of the internal audit function, the BNM issued BNM Guidelines on Minimum Audit Standards for Internal Auditor of Financial Institutions. Para 5.3.1 states that the internal auditor should immediately report to the audit committee and chief executive officer any significant audit findings uncovered in the course of audit that would adversely affect the financial institution's operation and financial condition. In addition, the BNM should be promptly informed of such audit findings. The Guidelines also provide that the chief of internal auditors of a financial institution should monitor all corrective actions taken by the management with regard to the BNM examination findings and report to the BNM any instances where corrective actions have not been taken.

It is noteworthy that the BNM's supervisory role to ensure safety, soundness and robustness of the financial institutions lies with the supervision functions of the BNM. In practice, the BNM works closely with both the audit committees and external auditors. As the work of the external auditor is used as input to BNM supervisory plans under its risk-based approach to supervision, BNM may, when necessary, expand the audit scope of the external auditors to address areas of supervisory concerns. This does not affect the expectation on external auditors to perform all necessary procedures in line with the auditing requirements. This communication keeps the channels open on the scope of audit assignments and problems arising from an audit, and on issues related to the application of the accounting standards (http://www.bnm.gov.my/).

2.8.4 Malaysian Institute of Accountants (MIA)

In 1967, the government legislated in the Accountants Act 1967 for the establishment of the Malaysian Institute of Accountants (MIA). According to the Act, the main function of the MIA is to regulate the practice and promote the interests of the accounting profession, to prescribe the minimum qualification of members and to register qualified accountants. MIA plays a vital role in ensuring that external auditing is conducted by qualified public accountants according to approved auditing standards. The MIA is responsible for issuing pronouncements on auditing matters and has issued By Laws

(On Professional Conduct and Ethics) for accountants in Malaysia. The role of the MIA will be further examined in Section 2.9.1.

2.8.5 Bursa Malaysia (BM)

Bursa Malaysia, as a front-line regulator of listed firms, is committed to maintaining high standards of corporate governance (CG) so as to maintain market integrity. BM was previously known as the Kuala Lumpur Stock Exchange (KLSE) which was established in 1973. It has continuously champion initiatives to promulgate the importance of listed firms embracing the best practices of CG.

In recognizing and subscribing to the importance of CG in the context of global capital market, Bursa Malaysia has taken a leading role in enhancing the standard of CG practices of listed firms (http://www.bursamalaysia.com/). The listing requirements issued by Bursa Malaysia incorporated rules on corporate governance and the requirements are regularly revised to meet the current needs. In 2008, subsequent to the revision of the Malaysian Code of Corporate Governance (MCCG) by the SC in 2007, BM revised its listing requirements to enhance the effectiveness and independence of audit committee and to mandate the internal audit function by listed firms. Details of the amendments which are pertinent to this study are found in Table 4.1 of Chapter 4.

2.8.6 Malaysian Accounting Standards Board (MASB)

In 1997, the Malaysian Accounting Standards Board (MASB) was established to harmonize the national accounting standards with the international accounting standards (http://www.masb.org.my). For this reason, MASB has been developing standards with reference to the accounting standards issued by the International Accounting Standards

Board (IASB). The MASB together with the Financial Reporting Foundation[11], an oversight body to MASB, provide the new framework for developing financial reporting standards in Malaysia (http://www.masb.org.my).

The new framework consists of an independent standard setting structure which incorporates the views of stakeholders including preparers, users, regulators and the accounting profession.

11 FRF is a trustee body, establish under the Financial Reporting Act 1997, which has the responsibility for the oversight of MASB's performance, financial and funding arrangements.

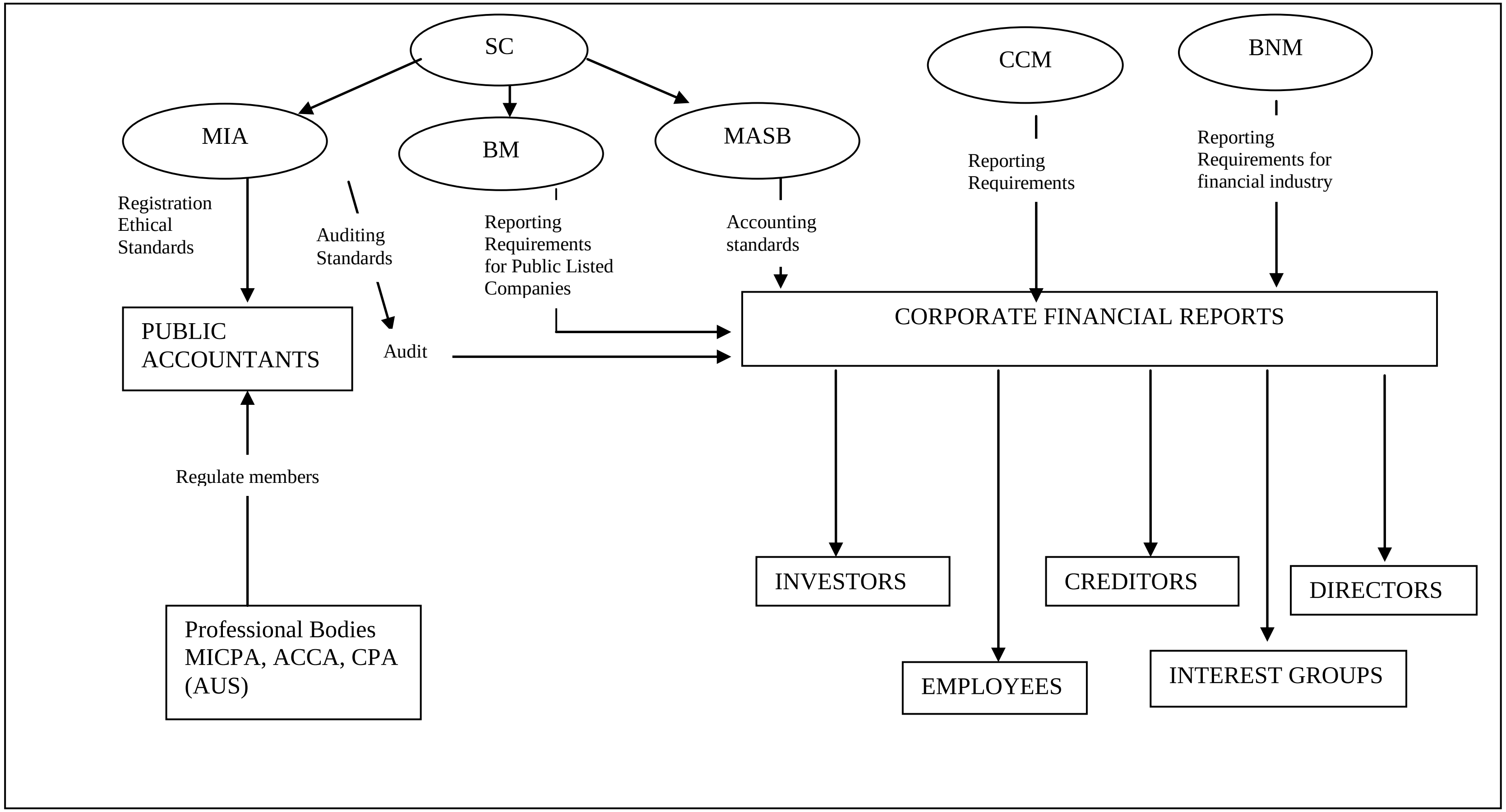

Figure 2.3: Regulatory Agencies in Malaysia
Source: Zakiah (2006)

2.9 Evolution of the Auditing Profession: A Summary

The auditing developments that took place due to the establishment of accounting and auditing professional bodies expected the role of auditors to converge (Lee and Azham, 2008). The changes made to the accounting and auditing regulations to a certain extent have implications for the role of external auditors in carrying out their audit engagements. The auditors do not only focus on preventing and detecting fraud and errors but also assess the truth and fairness of the firms' financial statements (Lee and Azham, 2008). The practice of auditing in Malaysia highlighted the financial reporting framework which includes the standards, legal responsibilities, codes of conduct and reporting requirements that guide an auditor's work. It also draws attention to the professional, regulatory and standard setting bodies that directly impact the auditing profession. Due to decisive changes made to the audit practice resulting from extensive global reforms, auditors are now expected to perform their duties to meet the expectations of the public, to maintain high standards of professionalism and to uphold a good reputation in the auditing profession (Lee and Azham, 2008).

In the US, several provisions of the Sarbanes-Oxley Act of 2002 have required additional audit procedures, and external auditors tend to charge higher audit fees (Jiang and Wu, 2009). Likewise in Malaysia, Yatim *et al*. (2006) support the finding that the increase in audit fees is due to changes in regulatory environment. Their results show there is an increase in audit fees after the corporate governance reforms in 2001. In 2008, further reforms were carried out to strengthen the board of directors and audit committee of listed firms. This research studies the impact of the 2008 reforms on audit fees.

2.9.1 Lowest Regional Audit Fees

In 1992, the Malaysian Institute of Accountants (MIA) was entrusted to promote and regulate the accounting profession and proposed a schedule for determining audit fees. The intention was to harmonise the fee setting basis and to minimize disparity in fees schedules (Akauntan Nasional, 1993).

Further, it was discovered that there were many firms which were audited by unqualified or unregistered accountants. Some of these "accountants" charged lower fees and abetted their clients in the falsification of their accounts. Further, these bogus practitioners resulted in a loss of confidence in the profession by not only the general public but also foreign investors (Akauntan Nasional, 1994).

Setting audit fees scales was thus essential to prevent undercutting and thus protect the auditing profession and industry. As stated by the then MIA's Public Practice Committee chairman's "in the past, there was no guideline whatsoever to say how much a firm should charge" (Akauntan Nasional, 1993). The audit fees schedule was approved by the MIA council in April 1993. Unfortunately, it did not have the force of law because the MIA issued it only as a guideline for audit practitioners in 1994 (Akauntan Nasional, 1994).

The guideline for audit pricing had not been fully adopted by most audit firms, yet there were numerous requests to review and regulate audit fees due to high costs incurred in maintaining office and hiring staff. To complicate matters, some auditors still practice undercutting. According to Lee, Azham and Gloeck (2009), this might be due to lack of enforcement by the regulatory authority.

2.9.2 Implications for Audit Fees and Audit Quality in Malaysia

Several key developments have occurred to guide auditors in carrying out audit practice more diligently and to enhance the integrity of financial statement audit. Over the years, stringent rules and regulations were imposed by the government which need to be fulfilled by external auditors. Hence, extra audit procedures need to be undertaken in performing the audit assignment. According to the Auditor General of Malaysia in 2010, Tan Sri Ambrin Buang, the number of fraud cases, forgery and corruption in corporate Malaysia are under control as the government has introduced new measures and policies to mitigate the risks (Business Times, July 26, 2010).

However, the reforms undertaken this far to increase audit quality may be hampered due to the shortage of qualified accountants in Malaysia. It is possible that one of the reasons for the lack of qualified accountants is due to the low audit fees imposed by local audit firms. This is further compounded by the global competition for human capital. Local audit firms are experiencing difficulties in hiring and retaining a qualified audit workforce as qualified accountants are paid much better in other countries like Singapore, China and the Middle East (Lee and Azham, 2008). Consequently, audit firms in Malaysia compete to hire young graduates who lack experience. This leads to the issue of audit quality.

The New Straits Times (April 11, 2011) reports that the audit fees charged by the auditors to their audited clients are too low to enable the auditors to perform their duties adequately. They are advised to command fees which commensurate with their duties in order to deliver high quality service that comply with international standards. Conversely, it may be argued that auditors could have performed the required duties but yet failed to prevent the financial scandals (Lee and Azham, 2008). As cited by Lee and

Azham (2008) from The Edge Malaysia on February 4, 2008 (p.20), an auditor commented that:

> *An auditor can improve and analyze the books, but in the end, the key is for management to practice good governance.*

The issue of charging low audit fees is still a problem in Malaysia (Devi and Samujh, 2010). To overcome this issue, audit firms should come to an agreement for a standardized audit pricing. Otherwise, auditors are likely to reduce audit procedures in order to cut the costs of performing the audit assignments. All in all, audit quality is likely to be sacrificed as a result of low audit fees while maintaining the profit margin. The issue of low audit fees has attracted a lot of interest among regulators and others, and thus this study is undertaken to find whether enhanced corporate governance reforms have contributed to raising audit fees.

2.10 Research Questions

Four research questions for the present study arose from the research gaps noted in this chapter. Whilst there are anecdotal claims that CG has been enhanced since 2007, there is no empirical evidence on the effectiveness of the revised BMLR 2008 on the internal governance mechanisms, namely, the audit committee and internal audit function, and their implications on audit fees for PCON and non-PCON firms.

The amendment to the Bursa Malaysia Listing Requirements (BMLR) in 2008 was designed to increase oversight and regulation for listed firms. The revised BMLR 2008 strives to strengthen the role of audit committees specifically on the effectiveness and independence of audit committees and mandating an internal audit function for listed firms. Yet, no study to date has specifically examined the impact of these revised listing requirements on audit committees, internal audit function and their implications on audit fees for PCON and non-PCON firms. This study is important as it seeks to evidence the moderating effect of political embeddedness on the enhanced CG environment on PCON and non-PCON firms. Since earlier studies have largely focused on PCON firms (Abdul Wahab *et al.,* 2009; Gul, 2006; Johnson and Mitton, 2003) and further the World Bank Report has raised concerns on the aspect of government equity ownership, this study also focuses on PCON firms which are said to be the favoured firms structure in Malaysia (Gomez and Jomo, 1999; Gul, 2006; Johnson and Mitton, 2003), vis-a-vis other ownership structures of institutional and managerial ownership firms (INST&MGRL) and family ownership firms (FAMILY), in the analysis. Hence, based on these arguments, the study raises the first and second research questions:

RQ1: Do PCON firms pay higher audit fees than non-PCON firms?

RQ2: Is the association between audit committee characteristics and internal audit function attributes, and audit fees stronger post BMLR 2008 implementation for PCON than non-PCON firms?

Further, there are limited studies examining the effect of regulatory oversight on the association between the internal governance mechanisms and audit fees for highly regulated firms (HRFs) and less regulated firms (LRFs). As discussed in Section 1.2.2.2 above, it is not clear whether the substitute or complement perspective will be observed in highly regulated firms in Malaysia. There is a gap in the audit fees research on the effect of regulatory oversight function on HRFs and LRFs in Malaysia. Thus, it is proposed that the regulatory regime in Malaysia should be examined in greater depth to offer a better and clearer understanding of the effect of regulatory oversight on the relationship between the internal governance mechanisms and audit fees. For that reason, this study investigates whether regulatory oversight moderates the relationship between the internal governance mechanisms of audit committee characteristics and internal audit function attributes, and audit fees. Therefore, the study addresses the following research questions.

RQ3: Do HRFs pay higher audit fees than LRFs?

RQ4: Is the association between audit committee characteristics and internal audit function attributes, and audit fees stronger post-BMLR 2008 implementation for HRFs than LRFs?

Based on the above research questions, this study extends the extant literature on audit fees and CG by evidencing the rise of the demand side explanation by investigating the internal governance mechanisms' impact post-BMLR 2008 implementation on audit fees for PCON and non-PCON firms and between highly regulated and less regulated firms, which assumes that:

1) enhanced audit committee characteristics will improve corporate governance; hence there will be higher audit fees due to the demand to safeguard reputational capital by the audit committee, and
2) enhanced internal audit function attributes will improve corporate governance, thus higher audit fees due to greater demand for extensive audit work by the audit committee, and
3) stringent regulatory oversight will improve corporate governance and higher audit fees due to demand for greater level of responsibility imposed on the audit committee together with demand for better quality of audit work by the external auditor.

2.11 Conclusion

This Chapter has identified the research gaps in the extant corporate governance and audit fees literature in the context of the emerging Malaysian economy that has undergone regulatory reforms to enhance its corporate governance practices and to remain competitive in this global economy. Whilst the issue of corporate governance and its implications for audit fees have been widely discussed in the context of more advanced economies, there is limited evidence of the impacts of the reformed CG on the audit fees in emerging economies. The next Chapter will discuss the theories related to the study, which are the agency theory, political embeddedness perspective and institutional theory to support the hypotheses development relating to the research questions identified in this Chapter.

Chapter 3 THEORIES UNDERLYING THIS RESEARCH

3.1 Introduction

This Chapter discusses the theories related to the study, which are the agency theory, political embeddedness perspective and institutional theory, to support the research questions identified in Chapter 2 and the hypotheses which will be developed in Chapter 4.

3.2 Underlying Theories in Research

Three theories are specifically drawn upon to provide the perspective for the research questions highlighted in Chapter 2. These are (i) the agency theory; (ii) the political embeddedness perspective; and (iii) the institutional theory.

3.2.1 Agency Theory

Most of the auditing and accounting studies on governance issues rests upon the foundation of traditional agency literature (Cohen, Krishnamoorthy and Wright, 2008). These studies examine the monitoring roles of the board of directors and audit committee on managers to protect shareholders' interests. The principal-agent approach was carried out further by Jensen and Meckling (1976), which highlights the importance of the relationship between shareholders and managers and at the same time to minimize agency costs.

This research uses an agency theory framework to examine the impact of having an audit committee that is independent, diligent and possesses accounting expertise, representing the interest of corporate owners as a counter to the potential self-interest of management. The 1970's work carried out by Jensen and Meckling (1976) resulted in a theory for understanding the implications of the separation of ownership from control. It identifies the agency relationship between the principal and its agent, whereby the principal engages the agent to perform some services on the principal's behalf and the principal will normally delegate some decision making authority to the agent.

Applying this to a corporate setup, managers have a conflict of interest with those of the shareholders. The managers, as agents, may be working to maximize their own personal gains rather than maximizing shareholders' value. Managers as agents are thus motivated by their own personal gains to the detriment of their principal's interests. According to Kiel and Nicholson (2003, p.29),

> *Agency theory suggests that professional managers can, by virtue of their superior knowledge and expertise, gain advantage of the firm's owners.*

Kiel and Nicholson (2003) present the view that the agency theory was widely adopted in the 1970's and 1980's due to the 'excesses' of the period. Managers making decisions on takeovers of firms were paying themselves large salary packages even when the businesses were non-performing. This type of behaviour needed to be controlled by the 'widespread adoption of an independent board mechanism to monitor a corporation's management' (Kiel and Nicholson 2003, p.30).

Gul and Leung (2004) highlight two problems related to the management process as a result of the separation between ownership and control. First, the goals of the principal and agent may not be aligned: the agent will act in his own self-interests and the principal is only interested in the financial returns. Secondly, the principal faces difficulties in observing its agent's action due to inadequate information about the business. Consequently, principals and agents have to invest in various information systems to reduce agency costs associated with information asymmetry (Jensen and Meckling, 1976; Fama and Jensen, 1983).

Agency problems will also arise when shareholders and managers have different attitudes towards risks (Arnold and Lange, 2004). Therefore, managers may not act in the best interests of shareholders and may prefer different actions to shareholders because they have different interests and risk preferences. This conflict of interests issue eventually gives rise to agency costs such as the costs associated with monitoring management, creating and implementing effective corporate governance.

In line with the positive accounting theory, opportunistic behaviour is assumed in agency theory, where individuals are assumed to act to maximise self interests. The positive theory which was introduced by Watts and Zimmerman in 1978 assumes that individuals act to maximise their own utility and consequently some decisions made by managers are motivated by self-interests, which reduces the welfare of the principal.

To overcome such issues, the board of directors is given the responsibility to monitor the management, who otherwise may act in their personal best interest and not in the interests of the principal (Fama and Jensen, 1983; Jensen and Meckling, 1976). Effective governance structures for the control of managers are vital. Some of the recommended governance structures are the board of directors, who are predominantly outsiders with no personal relationship with management, a chairperson of the board who is not an executive manager of the firm and a chief executive officer whose personal interests is aligned with shareholders through stock ownership or a bonus compensation plan that is linked to shareholders' wealth (Donaldson 1990, p.376). The role of corporate governance here is to protect the shareholders by monitoring managers through the board of directors. This is also the view adopted by statements of best practices on corporate governance such as the Australian Stock Exchange Corporate

Governance Principles (2003), OECD Principles of Corporate Governance (1999) and the Revised Malaysian Code of Corporate Governance (2007).

The agency theory asserts that a firm can employ various mechanisms to align the interests of agents and principals, and to monitor agents' behaviour (Jensen and Meckling, 1976; Preston and McMilan, 1991). Given its various responsibilities, the board normally delegates its financial oversight function to the audit committee (Mat Zain, 2005). Menon and Williams (1994) use the agency theory perspective to examine the argument that firms with high agency costs will attempt to mitigate these costs by undertaking increased monitoring activity through the audit committee. In other words, the presence of an audit committee who are independent, diligent and has financial expertise, functions as a monitoring mechanism that could reduce the agency costs. For the purpose of this study, the three (3) key organizational governance mechanisms of interest which will be examined are the audit committee, the internal audit function and the external audit as shown in Figure 3.1.

The role of the audit committee is to direct organizational resources towards establishing appropriate internal controls and other governance mechanisms. The internal audit function is another internal governance mechanism that undertakes analysis of activities within an organization and to make recommendations for the improvement of internal control and to promote efficiencies. The relationship between a firm's audit committee and internal auditors is crucial because the audit committee supports the internal audit function by reviewing the adequacy of the scope and the function of internal audit, providing adequate resources and facilitating communication with management (IIA, 1993). On the other hand, the internal auditors play an important role in overseeing the financial control and reporting environment of the firm.

Thus, it follows that an effective audit committee should improve internal control and act as a means of attenuating agency costs (Ho and Wong, 2001).

In sum, as internal governance mechanisms, both the audit committee and internal audit function can increase the monitoring of management and reduce the incidence of irregularities in the financial reporting.

However, it is observed that there is a preponderance of archival accounting and auditing literature that have taken solely an agency theory perspective, and are unable to detect the effectiveness of governance structure (Cohen *et al*., 2008). For example, measures of independence used in prior studies have led to inconclusive results because the proxies used may not reflect the actions and conduct of the board (Mac Avoy and Millstein, 2004). According to Mac Avoy and Millstein (2004), the construct 'independence' has proved difficult to capture using the agency framework.

This is also supported by Larcker, Richardson and Tuna (2007) who state that causal links between measures of governance quality and the performance of the firm is difficult to establish using an agency framework. They also highlight in their study the issue of whether audit committee independence really has an influence on governance. Thus, as suggested by Eisenhardt (1989), agency theory needs to be complemented with other theories. In the present study, the political embeddedness perspective and institutional theory are also applied to explain the governance issues.

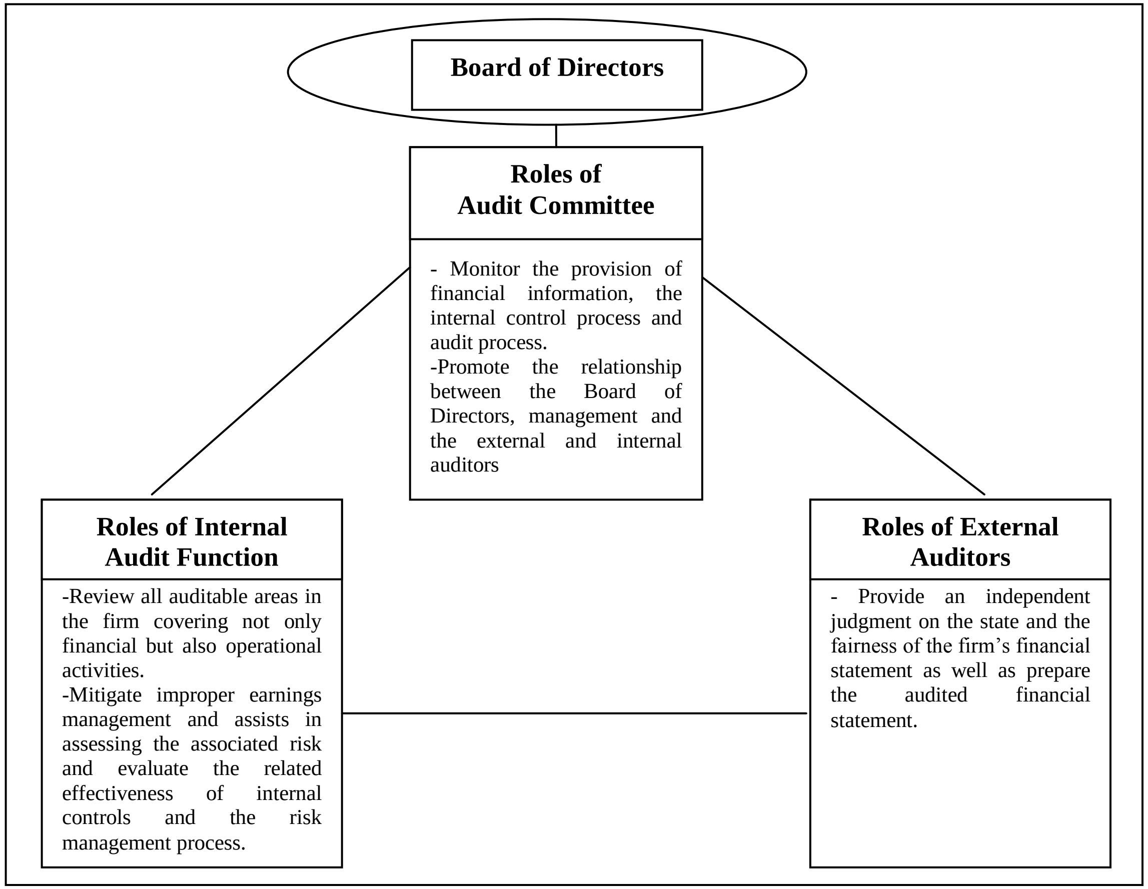

Figure 3.1: The Relationship between the Audit Committees, Internal Audit Functions and External Auditors

Source: Mat Zain (2005)

3.2.2 Political Embeddedness Perspective

Embeddedness is the degree to which individuals or firms are entangled in a social network. The term embeddedness involves the overlap between social and economic ties within and between organizations (Granovetter, 1985). The embeddedness perspective was developed under the economic sociology discipline (Granovetter, 1985; Polanyi, 1944; Portes and Sensenbrenner, 1993; Zukin and DiMaggio, 1990). The concept of embeddedness, which highlights the economic activity in institutions, was first introduced by Polanyi (1944). Later, Granovetter (1985) emphasized embeddedness of economic activity in ongoing patterns of social relations. His approach was further extended by researchers whose interests were in inter-organizational relationships (Dacin, Ventresca and Beal, 1999; Gulati and Gargiulo, 1999; Hagedoorn, 2006; Uzzi, 1996 and 1997).

The present study aims to extend the literature by (1) introducing the concept of political embeddedness to explain the position of politically connected firms, and (2) to highlight the professional and personal networking between the external auditors and former Big4 auditors employed by the audited firms.

Political embeddedness can be divided into four folds. First, political settings for networks, where the government provides *a framework of rules and regulations within which private actors have to play* (Salmi, 1995, p. 68). Secondly, the political actors have great influence in the government. The political or institutional actors include the bureaucrats, government ministers, and members of parliament, opposition parties, interest groups and the media (Hadjikhani and Håkansson, 1996). Thirdly, political activities by the firms involved in the political system (Halinen and Törnroos, 1998), such as lobbyists of government's contracts and to obtain government's funding. Lastly, the political resources that the firms hope to achieve from their political activities such as public sector contracts, licences and approvals, industry policies and legislative measures, support in the form of tax concessions, tariffs and other protectionist measures, funding for research and development and regional development (Hadjikhani and Sharma, 1996).

Politically connected firms are identified as firms having officers or major shareholders with close relationships with key government officials (Gomez and Jomo, 1997), and are associated with easier access to the government's valuable resources. A review of the literature has demonstrated the benefits of being connected to the government, for instance, research associated with political connections with the state government (Hillman *et al.,* 2004; Baum and Oliver, 1991; Xin and Pearce, 1996; Luo and Chen, 1997; Peng and Luo, 2000; Lester *et al.,* 2008: Siegel, 2007) and political networking (Faccio, 2006; Frynas, Mellahi and Pigman, 2006; Hillman, 2005; Peng and Luo, 2000). Generally, the politically connected firms will gain the upmost advantage by receiving valuable advice and by being in position to influence government policies.

In addition, firms with former government officials on the board are also said to be politically connected, because the ties facilitate access to resources controlled by the government. Schaede (1995) explains the "Old Boys" network about the re-employment of retired former government officials in private or quasi-private firms, due to their expertise and networking during their stint as a bureaucrat. The intention is to get access to the governmental information and for lobbying with the government for continued protection. Besides that, these firms are given privileges over their competitors when applying for licences, tax exemptions, and government contracts. Thus, the presence of current or former government officials on the board may create a situation of high political embeddedness.

However, political embeddedness is also associated with costs. In a situation where the political connection is through the board of directors, the government officials in their capacity as the firm's directors influence the firm's governance process. Though the law requires directors to act for the benefit and best interest of the firm, the directors who are also government officials represent the government's interests. As the interest of the government might diverge from those of the firm and its shareholders (Aharoni, 1986), the directors may promote strategies from the government's view rather than from the firm's view.

The political embeddedness perspective may also be pertinent to explain the corporate setting in Malaysia, where PCON firms have ties with certain political party or politician. As discussed earlier in Section 2.6 of Chapter 2, the existence of the PCON firms is due to the Malaysian government's intervention to increase Bumiputra equity ownership. The intervention started with the introduction of the New Economic Policy (NEP) in 1971 and continues to grow since then. This is because from a political perspective, equitable distribution of corporate wealth is the key element under the national development policy.

Further, the government has also given much attention and initiatives to ensure that the favoured firms perform in an effective way and assist the government to improve the economic growth. These favoured firms are now more conscious of good governance and are expected to improve its business performance[12]. Nevertheless, the government

[12] Refer to Section 6.4.8 for further discussion

has also from time to time supported Chinese firms by channelling contracts to them. These favoured Bumiputra and Chinese firms could access resources, funds and opportunities to build new wealth through politics (Gomez and Jomo, 1999).

It is also argued that politicians or political parties invest in the corporate sector by using Bumiputra leaders as proxy investors (Gomez and Jomo, 1999). With their close relationship with politicians, these favoured firms could influence policy making and make business opportunities more accessible for their firms. At the same time, they assist the government in fulfilling the objectives of socio-economic policy and raising the status of Bumiputra in the corporate sector. Thus, politics has a role in the favoured firms' performance by bringing growth and expansion to them through favourable deals and access to opportunities (Gomez and Jomo, 1999).

In addition, the political embeddedness perspective may also be used to explain embedded relationship between the two key actors of the audit process namely, the external auditors with the members of the audit committee and employees of the audited firm. This is due to the fact that an external auditor plays an advisory role which embeds his relationship with the audited firm in the audit process. According to Richard (2006), the relationship between the audited firm and the external auditors' team can be divided into a professional and personal relationship.

According to Williamson (1994), the professional relationship is described to be like an economic exchange, framed by professional standards with the intention to create barriers preventing the development of informal engagements during the formal audit process (Ring and Van De Ven, 1989). On the other hand, personal relationship is defined as a social exchange, implying in particular obligations that are not specified a priori (Blau, 1964).

Professional and personal relationships need to be based on trust. Trust between the manager and the auditor transpires from a professional and personal relationship. Professional trust can be defined as "the probability that this one carries out an action that is beneficial or at least non-prejudicial is rather strong according to us to consider that we can engage in a form of a cooperation with him" (Gambetta, 1988, p. 217). In contrast, personal trust is referred to as "a belief of a person in the integrity of another person" and "exists insofar as a person believes that another person is benevolent and honest" (Larzelere and Huston, 1980, p. 595).

The audit committee nominates the external auditor, assesses its independence and discusses the audit scope. Open communication between the external auditor and audit committee is imperative for a successful relationship. It is important that the audit committee and the external auditor communicate effectively to ensure that an appropriate balance exists. In the audit process, professional relationship and personal relationship between the audit committee members who are former Big4 auditors and the external auditors also can be called the "Old Boy" network (Schaede, 1995). The former Big4 auditors have a better understanding of the audit process and empathise with the low fees. As supported by Devi and Samujh (2010) that Malaysia's audit fees are still the lowest in the ASEAN region and thus, the audit committee's demand for more audit procedures and are willing to pay higher audit fees to the external auditors.

With regards to this study, Table 3.1 shows the number of the former Big4 auditors appointed by the politically connected firms in 2009. Out of 67 PCON firms, 40 firms appointed former Big4 auditors as members of the audit committees (39), chief executive officers/managing directors (7), chief operating officers/chief financial officers (5) and non-executive directors (7). Thirty-three percent of audit committee members in PCON firms are former Big4 auditors; 17.5 percent of the chief executive officers/managing directors, 12.5 percent of the chief operating officers/chief finance officers and 10.1 percent of the other non-executive directors are also former Big4 auditors.

To conclude, existing literature on political embeddedness represents a useful starting point for research into the political dimensions of corporate governance in Malaysia due to its unique corporate settings. Political embeddedness perspective explains the political relationship between the government and its favoured firms. In a political relationship, exchange of information and interest are made between the favoured firms and government or political players, whereby, the firms obtain advantages of the government resources. In return, these firms will assist the government (Hadjikhani and Ghauri, 2001) by having acting government officials on the boards of firms (Hillman, 2005).

In adopting the political embeddedness perspective, this study incorporates the first dimension on ownership and directorship of government officials under political influence. It takes cognizant of the unique Malaysian political economy with politically connected (PCON) firms with strong ties with the government to achieve their mutual objectives. Such favoured firms play an important role in corporate Malaysia.

Table 3.1: PCON firms with former Big4 auditors in 2009

Total number of AC members	Total number of former Big4 auditor as AC members	Total number of CEO/MD	Total number of former Big4 auditor as CEO/MD	Total number of COO/ CFO	Total number of former Big4 auditor as COO/CFO	Total number of NED other than AC	Total number of former Big4 auditor as NED
117	39 (33.3%)	40	7 (17.5%)	40	5 (12.5%)	69	7 (10.1%)

Source: Respective PCON firms annual report 2009

In addition to the political embeddedness perspective, the Malaysian institutional setting is also unique in the sense that it has instituted strong regulatory oversights over its corporate sector. To accommodate this, the institutional theory is drawn upon to examine the existence of varying degree of oversight over Malaysian firms.

3.2.3 Institutional Theory

Institutional theory reinforces the importance of understanding the interactions between governance key players and other governance parties (Cohen *et al*., 2008). The institutional theory identifies the relationship between regulators and firms. These regulatory agencies are empowered to monitor and inspect compliance using international and local standards, as well as to investigate suspected non-compliance and impose appropriate sanctions on delinquent firms. Fogarty and Kalbers (1998) apply the institutional theory in their study to evidence that institutional support together with strong management and board diligence enhance the effectiveness of the audit committee. They conclude that audit committee members are operating in an institutionalized environment in order to achieve their authority.

An institution is defined as *"the shared and taken for granted assumptions which identify categories of human actors and their activities and relationship"* (Burns and Scapens, 2000, p.8). It does not only embrace the structures, policies and procedures of a specific organization, but it also consists of other organizational systems which come together to achieve the same objectives (Khadaroo and Shaikh, 2007). Some of the common objectives in relation to corporate governance are promoting corporate governance best practices, formulating and enforcing the accounting standards applicable to listed firms. These structures and systems will develop progressively through changes in rules and regulations by the regulators.

Institutions tend to function best under governmental units, highly regulated organizations and also private sector units which are highly dependent upon public financing (Fogarty, Bealing and Dirsmith, 1996). This common regulatory environment has been cited as one of the forces in dictating various characteristics of a firm's conduct and configuration including external reporting requirements. Organizations obey these rules and requirements not just on efficiency grounds but also to enhance their legitimacy, resources and survival capacities (Kondra and Hinings, 1998).

It thus follows that apart from the agency theory, institutional theory has been applied to examine issues in corporate governance. Institutional theory provides a framework for better understanding of the socio-economic and legal influences on countries and organizations, and its strategic response to those influences (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Covaleski and Dirsmith, 1988; Carruthers, 1995; Brignall and Modell, 2000; Hussain and Hoque, 2002; Khadaroo, 2005; Khadaroo and Shaikh, 2007). Institutional theorists refer to the possibility for countries and organizations to become similar overtime through the process of homogeneity. The process of homogenization is known as 'isomorphism' (DiMaggio and Powell, 1983).

Isomorphism is divided into three avenues that are coercive, normative and mimetic pressures which operate in the institutional environment, to explain about organizations or countries adopting similar practice (DiMaggio and Powell, 1983). Coercive isomorphism results from external regulatory-type pressure for organizational convergence (Cohen *et al*., 2008). Organizations are experiencing formal and informal pressures from other organizations on which they are dependent. Such pressures may be felt as force or persuasion as a direct response to government directives. Normative isomorphism, however, is primarily from professionalization (DiMaggio and Powell, 1983) and there are various kinds of professionals within an organization. Though they differ, they have similarities with their professional counterparts in other organizations. Mimetic isomorphism results from significant environmental uncertainty, which is a powerful force that encourages imitation (DiMaggio and Powell, 1983). It happens when organizations tend to model themselves after other similar organizations that they perceive to be more successful. According to Cohen *et al.* (2008), the modelling is a response to uncertainty and the modelled organization may have no intention to be followed by other organizations.

It has long been recognized that firms exercise vast powers in modern societies. The concern for regulating such power and ensuring its accountability has been at the centre of analysis and debate. The establishment of regulatory agencies, which have been charged with the responsibility for controlling the powers of firms, should be mandatory (MICG, 2001). This is because the collapse of conglomerates has affected not only developed countries but also developing countries such as Malaysia. In addition, financial scandals and irregularities have once again focused attention on the oversight roles of the accounting profession, Bursa Malaysia, Securities Commission and Bank Negara Malaysia. It is vital to have an institution or agency that can monitor the operation of the firms so as to reduce or minimize corporate failures. It has always been accepted that however many laws or regulations there are, situations will occur from time to time highlighting the inadequacy of such laws or regulations. It is thus necessary to review the law and regulations regularly (MICG, 2001).

Regulations articulate clear standards of corporate governance which reflect society's expectations of best practices and standards of ethical behaviour. Some of these standards are set down as codes of practices whilst others are embedded in law reforms proposal (MICG, 2004). It is the responsibility of the national regulatory agencies to ensure robust and effective monitoring and surveillance of firms and market operations. This task is made more difficult by the integration of financial institutions and activities, the impact of technology on the speed of financial and information flows, and the internationalization of economic activity (MICG, 2004).

In the accounting literature, institutional theory has been applied to a wide variety of situations. For example, Bealing *et al.* (1996) studied the historical development of the US Securities and Exchange Commission (SEC) and in particular, the form and content of its early regulatory actions as a case example of an organization attempting to justify its existence and role in financial markets. Other management literature discusses institutional theory in terms of legitimacy. According to Suchman (1995), institutions respond to threats to legitimacy with organizational changes and organizational communication. Another study finds that leaders of an institution which is facing structural change tend to engage in fawning behaviour in order to preserve power (Westphal, 1998).

In addition, institutional theory may also be used to explain the role of audit committees in firms. As indicated by Meyer and Rowan (1977), organizational structures become symbolic displays of conformity and social accountability. The establishment of audit committees is said to offer an example where the theory suggest that organizational legitimacy may be secured by the use of myth and ceremony that link organizations to their external environments. Supported by Beasley, Carcello, Hermanson and Lapides (2000), the audit committee acts as a symbolic function and serve as a symbol of effective oversight. Some researchers use institutional theory to investigate whether audit committee plays its role in monitoring by accomplishing a given task or is there any 'loose coupling' in existence (Fogarty and Kalbers, 1993 and 1998; Spira, 1999).

Eisenhardt (1988) finds that institutional theory is applicable in a complex and dynamic situation. In order for organizations and regulators to interact with one another, they have to comply with specific practices and procedures. Notwithstanding this apparent relevance of institutional theory to quasi government institutions such as the SEC in the US, Meyers and Rowan (1977) argue that listed firms are also facing significant institutional pressures to conform and legitimize their practices and operations. The effectiveness of regulations on firms varies among countries and many countries allocate few resources to enforce their regulations. Further, it is the responsibility of the regulatory agencies having oversight authority over accounting matters (Baker *et al.*, 2006) to restore public confidence by enforcing governance practices.

In the case of Malaysia, the regulatory framework has undergone tremendous changes so as to further strengthen the country's financial and capital markets (Abdul Rahman, 2006). The financial crisis in 1997 seems to have 'coerced' South-East Asian countries, including Malaysia, into reforming their existing corporate governance structures. The diverse institutions which were set up by the respective governments illustrates the 'normative' influence of government securities market regulators, professional bodies, the market and other interest groups in promoting good corporate governance practices. These corporate governance best practices are not specific to any country but rather are adopted by many countries internationally through 'mimetic' processes (Khadaroo and Shaikh, 2007).

In Malaysia, several regulatory and administrative agencies were established to improve and also oversee the corporate governance of firms. These were examined in Section 2.8 of Chapter 2. For instance, the Securities Commission (SC) was established to encourage good governance among firms with the objective of raising shareholder value. In this regard, the Securities Commission has also identified numerous other specific recommendations for strengthening corporate governance, including further enhancing shareholder rights, especially those of minority shareholders' and broadening avenues for private enforcement of these rights to firms (http://www.sc.com.my).

Thus, in 2001, the Minority Shareholder Watchdog Group (MSWG) was established to create awareness among minority shareholders of their rights, and to act on behalf of minority shareholders so as to deter abuses by majority shareholders. This is part of the broader capital market framework to protect the interest of minority shareholders through shareholder activism (Zakiah, 2006).

Further, the establishment of the Audit Oversight Board (AOB) in 2010 follows the footsteps of the US (the Public Company Accounting Oversight Board (PCAOB), the UK (the Professional Oversight Board for Accountancy), Australia (the Auditing & Assurance

Standards Board which sets auditing standards, and a Financial Reporting Council that monitors auditor independence), Egypt, Lithuania, Mauritius and Sri Lanka. All these countries have established some form of independent regulatory oversight over their respective auditing professions, but with differing levels of empowerment (Accountants Today, 2008).

In Malaysia, the AOB was established to create a new governance structure that underscores auditors' responsibilities in financial statement reporting (The Star, April 2, 2010). The AOB was established under Part III of the Securities Commission Act 1993 to promote confidence in the quality and reliability of audited financial statements in Malaysia. The need to reform the current audit oversight framework is seen as a direct response to the serious irregularities in financial reporting in Malaysia (http://www.sc.com.my). The AOB is said to provide an independent oversight and regulation of external auditors of listed firms in Malaysia. The AOB has power to reprimand auditors who have committed wrongs including issuing penalties and deregistering them from audit practice (The Star, 2 April, 2010). Strengthening audit quality and ensuring ethical behaviour among accounting professionals is critical if Malaysia wants to be at par with the global financial and capital markets (Nazatul, 2009).

The establishment of an independent oversight body is pertinent in view of the emergence of audit failures which has focused the world's attention on accounting standards and the role of auditors. One cause of corporate collapse is the lack of professionalism and the failure of the auditing profession itself. Thus, auditors are facing new challenges that require them to be more competent to face the global capital market (Lee and Azham, 2008). In order to diverge, auditors should be able to reinvent themselves and be prepared for more challenges. Due to this, the government of Malaysia has made efforts to ensure that the board of directors, audit committee and external auditors are able to comply with stringent and rigorous standards imposed by the statutory bodies so as to enhance audit quality in line with international benchmarks (MICG, 2004).

To overcome such issues, the Bursa Malaysia (BM) revised its Listing Requirements, mandating listed firms to comply with certain Best Practices recommended by the Malaysia Code of Corporate Governance (MCCG). Subsequent to the Revised Code 2007, the Bursa Malaysia further reviewed its listing requirements in 2008 to enhance the effectiveness of internal governance mechanisms in listed firms. The new BMLR 2008 stipulates the eligibility criteria for appointment to the audit committee, the composition of the committee, the frequency of meetings and the need for continuous training. In addition, internal audit functions are required in all listed firms and the reporting line for internal auditors are clarified (more specifically, Para (30) Appendix 9C, Para 15.10, 15.13 and 15.28 of BMLR 2008).

These amendments to the listing requirements by the Bursa Malaysia are primarily in response to the coercive pressures by the developments of domestic and international capital markets, and normative pressures from the shareholders and the public to assess and determine the standards of corporate governance by listed firms (Khadaroo and Shaikh, 2007). It was expected that by mimicking the international best practices (MCCG, 2007), these amended listing requirements would strengthen the board and audit committees, ensuring that they discharge their roles and responsibilities effectively.

In addition, as discussed in Section 2.8.3 of Chapter 2, Bank Negara Malaysia (BNM) provides stringent regulatory oversight on all financial institutions and insurance firms. BNM has the power to examine the books and accounts of these highly regulated firms as well as the power to approve the appointment of external auditors, directors and chief executive offices of these firms. Further, BNM has power to instruct the external auditor to expend his /her audit scope as well as require the auditor to report and provide additional information to it. The presence of BNM as an additional industry-specific regulator for HRFs has enforced tighter regulations so as to ensure that effective policies and practices are followed[13].

Based on the above arguments on the regulatory reforms under institutional perspective, it can be concluded that the Securities Commission, Bursa Malaysia and Bank Negara Malaysia are the key players in 'legislating' good governance to 'coerce' firms to comply with the rules and regulations. These regulators do not act unilaterally but coordinate their activities by interacting and responding to pressures from professional bodies, industry participants and other organizations (i.e. MSWG, AOB, MCCG) (Khadaroo and Shaikh, 2007). They raise the standards of corporate governance in Malaysia by strengthening self and market discipline and promoting greater internalisation of the culture of good governance. Thus, it can be concluded that the Malaysian approach to corporate governance is rather geared towards regulation. Hence, the existence of the regulatory oversight and audit fees gaps arguably needs to be addressed and investigated so as to offer a better and clearer understanding on corporate governance issues.

[13] This will be further discussed in Section 2.8.3 of Chapter 6)

3.3 Gaps in Theoretical Arguments

As noted from the above discussion, though the agency theory has dominated most of prior literature, studies which have taken solely an agency theory perspective have been unable to detect the effectiveness of governance structure comprehensively (Cohen *et al*., 2008). Scholars have criticised the enactment of government regulation, for instance the Sarbanes-Oxley Act (SOX) 2002 in the US (Cohen *et al*., 2008), which draws upon the prescriptions of the agency theory. There is little evidence to support the contention that the theory acts as an effective model for organizational behaviour. Cohen *et al*. (2008) in their literature survey, observe that there is limited auditing research that considers the institutional theory. The advantages of using multiple theoretical perspectives with regards to governance have been well recognized in the economics and behavioural literatures (Cohen *et al*., 2008). Due to the fact that the agency theory does not completely represent the complexity of an organization, additional perspectives such as the political embeddedness perspective and institutional theory can help to capture the reality. This study adopts the three theories to examine the interaction between the internal governance mechanisms of audit committee characteristics and internal audit function attributes, and audit fees.

3.4 Conclusion

Whilst extant corporate governance literature has largely drawn on the agency theory to explain the corporate governance mechanisms and their effects on audit fees, this study draws on two additional perspectives, political embeddedness and institutional theory to appropriately reflect the unique corporate setting in Malaysia.

Using the agency theory, political embeddedness perspective and institutional theory, the audit committee, internal audit function and regulatory oversight are seen as part of the corporate governance system. A review of previous literature indicates that even though considerable work has been done on politically connected firms and to determine the factors that influence audit fees, it is yet to be discussed if those findings still apply in a different institutional and regulatory regime post-2008.

Additionally, the effective and efficient roles of regulators have significant implications on organizations. However, no studies have yet examined the moderating effect of regulatory oversight on the association between the internal governance mechanisms and audit fees in Malaysia.

Thus, the aim of this study is to fill that knowledge gaps in research with the prime objective to investigate the effect of political embeddedness and regulatory oversight on the relationship between audit committee characteristics, internal audit function attributes and audit fees. The next chapter will discuss the research methodology and research framework and resulting hypotheses to be tested in this thesis.

Chapter 4 RESEARCH METHODOLOGY

4.1 Introduction

The purpose of this Chapter is to discuss the research methodology, develop the research models drawing upon the theories discussed in Chapter 3 and formulate the hypotheses relating to the research questions. The study comprises of two research models. The first research model addresses the moderating effect of political connections on the association between audit committee (AC) and internal audit function (IAF), and audit fees using sampled firms comprising PCON and non-PCON firms operating within a low regulatory regime. The second research model examines the moderating effect of regulatory oversight on the association between AC and IAF, and audit fees using sampled firms operating in high and low regulatory regime. Prior to formulating the hypotheses, the definition and the reasons for selecting the variables of this study are provided. Appropriate research models are developed to support the hypotheses development.

4.2 Methodology

In general, methodological approaches can be divided into three views, namely the positivist perspective, interpretive perspective and critical perspective. Positivism is associated with scientific, experimental, quantitative and deductive frameworks (Ticehurst and Veal, 1999, p.20). Positivist researchers seek precise quantifiable observations and they often use statistics and experiments to test their hypotheses (Neuman, 1997, p.63). The interpretative approach attempts to understand the view point from the subjects' perspective. The researcher 'interprets' the information provided based on the understanding of the situation and is therefore 'part of the research process' (Ticehurst and Veal, 1999, p.20). The critical perspective expands the interpretive approach by focusing on the ownership of knowledge and the associated social, economic and political implications (Smith, 2003).

Audit pricing research has always been approached from the traditional positivist research methodology which yields results that may not give a full account of what determines and influences audit fees. This mainstream approach gives the perception that the actors within the audit pricing discourse are objective and rational by nature during the course of their interactions. Positivists believe it is possible to classify the social world in an objective way which can be quantified using statistical data. Using these classifications, it is then possible to count sets of observable social facts and to produce statistics (Smith *et al.,* 2002). Whilst there are increasing studies using alternative paradigms to investigate corporate governance phenomena, the audit fees issue has been largely situated in the positivist paradigm. The reason why the positivist approach is dominant in the literature is because researchers tend to build upon the work of their predecessors who identify key variables and ideas that are expanded in future research under a positivist methodology. In doing so, they have tended to advocate the use of quantitative methods.

Large body of research has examined the determinants of audit fees over the past 25 years and much of the research has followed from the original seminal work by Simunic (1980) (as cited in Hay *et al.,* 2006). The majority of the previous studies use mainstream accounting research method and have tended to advocate the use of quantitative methods and undertake a positivist perspective. This is also supported by Chua (1986), whereby positivism has become the mainstream accounting research method and leading accounting academic journal preference. According to Lowe and Lock (2005 and 2008), the majority of accounting research is still in the positivist paradigm.

This study starts with three theories namely, the agency theory, the political embeddedness perspective and the institutional theory, and proceeds to generate specific predictions to test the hypotheses as a deductive reasoning. In general, there are two major processes of reasoning that will provide better explanations and more reliable predictions (Smith, 2003). The two processes of reasoning are deductive and inductive reasoning. The deductive research process involves the development of a theory and proceeds to generate specific predictions which follow from its application. The inductive approach is used when data is collected first, and a theory is developed as a result of the data analysis. The deductive approach tends to be favoured by positivist researchers (Ticehurst and Veal 1999, p.22). It is dominant in the natural sciences where research is carried out to explain causal relationships. The research approach uses 'a highly structured methodology' and collects data that 'can be measured quantitatively' (Saunders and Lewis, 2003, p.86). On the other hand, the inductive approach emerged due to the problems with rigid methodology of the deductive approach. The development of the social sciences required researchers to be able to understand the different ways people interpret their situation. This approach may be considered more appropriate for small sample studies using qualitative data gathering techniques (Saunders and Lewis, 2003, p.88).

4.3 Data Collection Review

To gather a full range of views on the internal governance mechanisms of audit committee characteristics and internal audit function attributes, and their implications on audit fees, this study employed mixed methods whereby, both semi-structured interviews and secondary data were collected. In the first phase of data collection, interviews were conducted with two regulators, three external auditors and three heads of internal auditors to elicit their perceptions on the BMLR 2008 on audit committee characteristics and internal audit function attributes, and their implications on audit fees.

The second phase of the of data collection aims to investigate the enhanced internal governance mechanisms of audit committee characteristics and internal audit function attributes, and their implication on audit fees. In addition, this study also aims to examine the moderating effects of political connections and regulatory oversight on the association between the enhanced internal governance mechanisms of audit committee characteristics and internal audit function attributes, and audit fees.

4.4 Phase 1: Interviews

The interview phase was conducted prior to determining the research questions and hypotheses in order to confirm the predominance of the demand perspective. The interviews were also useful to provide insights to the archival data analysis in Phase 2.

4.4.1 Interview Administration

In Phase 1, data was collected through interviews with selected external auditors and heads of internal auditors. They were chosen based on their in-depth understanding of the audit fees issue and its impact on other internal governance mechanisms such as audit committee and internal audit function. Due to growing attention given to the issue of audit fees, regulators were also included as participants in this study. Respondents from these different groups were selected based on the research expectation on the interrelationships between the various actors and mechanisms within corporate governance. The interactions among these corporate governance key players are important in order to achieve effective governance in an organization, as described in Chapter 2.

The face-to-face interview method was chosen so as to obtain a better understanding about the enhanced corporate governance and its implications on audit fees. Semi-structured interviews which are appropriate for exploratory study of this nature (Kidder and Judd, 1986) were conducted. The interviews were designed to enhance and supplement the information gained from archival data collection. The use of this method is important because it provides an interpretation of people's opinions and experience which helps to gather in-depth knowledge in addition to quantitative findings. This approach also enables the researcher to gain better understanding from the viewpoint of the participants (Parker and Roffey, 1997).

The interviews were conducted in the respondents' respective offices and a semi-structured interview guide was given prior to the interview. The average time for the interviews was 45 minutes. The interview sessions started with the general question "How would you describe corporate governance in Malaysia?" The number of questions asked in each interview was not predetermined. During the interviews, the discussion flowed according to the information furnished by the interviewee but was guided by the semi-structured interview guide.

4.4.2 Sample Selection

The total number of respondents sampled in this study is eight. Sampling was stopped once data saturation occured that is when the sample did not yield new information relevant to the emerging themes in the study. The subjects for the interviews in this study were the regulators (2), heads of internal auditors (3) and external auditors (3). The respondents were chosen based on their experience and knowledge for this research. Five out of eight interviews were tape-recorded with the permission of the respondents and the other three respondents did not grant permission. As a result, notes were taken to document responses from them.

All respondents appeared to be confident and had a thorough understanding of their scope of work. The data from the interviews were transcribed into written text before analysis. The transcribed data were then coded using individual themes as the unit of analysis, which are related to the main research questions (Patton, 2002). Coding sample text, checking coding consistency, and revising coding rules were done continuously until sufficient coding consistency was achieved (Weber, 1990). A matrix framework was used to compare the responses across eight respondents are further discussed in Chapter 6.

4.4.3 Semi-structured Questionnaires

The questionnaire was divided into five sections as follows:

Section A comprises of a number of general questions pertaining to the demographic background details such as the respondent’s gender, age group, professional memberships, and his/her working experience in the relevant field.

Section B begins by asking questions in relation to corporate governance and auditing issues, such as the role of audit committee and internal auditors, the BMLR 2008 revision affecting the job functions of external auditors, and the reliance on internal audit function contribution by external auditors.

Section C requires the respondents to provide his/her opinion on PCON and non-PCON firms in Malaysia, and the governance practices for the different types of ownership structured firms and the audit fees charged.

Section D enquires about governance of highly regulated and less regulated firms, and the respondents' understanding and knowledge on the implication of BMLR 2008 on these firms. It also seeks the respondents' opinion on the effectiveness of the additional industry-specific regulator, and audit fees charged for the HRFs.

Section E enquires about the enhanced CG's implications on audit fees, and the audit fees charged by external auditor for audit client.

A copy of the semi-structured interview and statement of confidentiality are attached in Appendix C.

4.5 Phase 2: Archival Data

The main objective of the secondary data collection in this study is to test the hypotheses which were developed in Chapter 4. With regards to quantitative method of data collection, this study uses sample firms from year 2005 until 2009 annual reports that are before and after the revision of the Bursa Malaysia Listing Requirements 2008 (BMLR 2008). The pre-test period covers the time frame from 2005 until 2007 and the post-test period covers years 2008 and 2009. This gives allowance to the timeframe for compliance which took effect at latest by 31 January 2009.

With reference to Table 4.1 below, the functions and composition of audit committee need to be disclosed in the annual report latest by 1 April 2008 and 31 January 2009 respectively. As for the statement of internal audit function, the information must be disclosed in the annual report for financial year ending on or after 31 January 2009. The other amendments to the BMLR relevant to this study took effect immediately. In addition to the above in 2004, the BNM issued guidelines on Corporate Governance for Licensed Institutions to promote the adoption of effective and high standards of corporate governance practices by financial firms and their holding firms (Appendix A).

The broad principles, standards and requirements under the guidelines are aligned with, among others, the principles enshrined in the Malaysian Code on Corporate Governance and the Bank for International Settlement (BIS) Guidelines. The guidelines on corporate governance for financial firms were revised in 2011.

Table 4.1: Amendments to the Bursa Malaysia Listing Requirements in 2008

Existing Provisions (BMLR 2001)	*Amended provisions (BMLR 2008)*	*Timeframe for compliance*
<u>*Audit Committee Characteristics*</u>		
Para 15.10, (1): Composition of the audit committee	**Para 15.10, (1): Composition of the audit committee**	By **31 January 2009.**
(a) the audit committee must be composed of no fewer than 3 members.	(a) (no change)	
(b) a majority the audit committee members must be independent directors.	(b) all the audit committee members must be *non-executive directors, with a majority of them being* independent directors.	
(c) at least one member of the audit committee: (i) must be a member of the Malaysian Institute of Accountants; or (ii) if he is not a member of the Malaysian Institute of Accountants, he must have at least 3 years' working experience and:- (aa) he must have passed the examinations specified in Part I of the 1st Schedule of the Accountants Act 1967; or (bb) he must be a member of one of the associations of accountants specified in Part II of the 1st Schedule of the Accountants Act 1967; or (iii) fulfils such other requirements as prescribed by the Exchange.	(c) (no change)	

Para 15.13 (1): Functions of the audit committee	**Para 15.13 (1): Functions of the audit committee**	
(e) the adequacy of the scope, functions and resources of the internal audit functions and that it has the necessary authority to carry out its work.	(e) the adequacy of the scope, functions, *competency* and resources of the internal audit functions and that it has the necessary authority to carry out its work.	Audit committee must begin discharging this function with effect from **1 April 2008**.
Para 15.16 (3): Audit committee report	**Para 15.16 (3): Audit committee report**	
(c) the number of audit committee meetings held during the financial year and details of attendance of each audit committee member.	(c) (no change)	
(e) the existence of an internal audit function or activity and where there is such a function or activity, a summary of the activities of the function or activity. Where such a function or activity does not exist, an explanation of the mechanisms that exist to enable the audit committee to discharge its function effectively.	(e) a summary of the activities of the internal audit function or activity.	
Para 15.18: Rights of the audit committee	**Para 15.18: Rights of the audit committee**	
(f) be able to convene meetings with the external auditors, excluding the attendance of the executive members of the committee, whenever deemed necessary.	(f) be able to convene meetings with the external auditors, *the internal auditors or both*, excluding the attendance of *other directors and employees of the listed issuer, whenever deemed necessary.*	
(d) Have direct communication channels with the external auditors and person(s) carrying out the IA function or activity	(d) have direct communication channels with the external auditors and person(s) carrying out the IA function or activity	

Internal Audit Function Attributes

Appendix 9C Part A Para 30: Statement on internal audit function	**Appendix 9C Part A Para 30: Statement on internal audit function**	
None	*A statement relating to the internal audit function of the listed issuer, i.e. whether the internal audit function is performed in-house or its outsourced and the costs incurred for the internal audit function in respect of the financial year.*	Annual reports for financial years ending on or after **31 January 2009** must contain the statement on internal audit function.
Para 15.28 Part F : Internal audit function	**Para 15.28 Part F : Internal audit function**	
None	*(1) A listed issuer must establish an internal audit function which is independent of the activities its audits.* *(2) A listed issuer must ensure its internal audit function reports directly to the audit committee.*	By **31 January 2009.**

Source: Compiled from Bursa Malaysia (2001 and 2008)

The population of the study are the firms listed on the Bursa Malaysia. There are 831 listed firms as at January 6, 2011. This study limits its sample to annual reports for 209 firms (1045 firm year-observations) in financial and non-financial industries for years 2005 to 2009, representing 25.2 percent of the population. The main criterions for selecting the sample are based on (a) the availability of full set of data from annual reports and *DataStream* for years 2005 to 2009, (b) firms that are no longer in existence are excluded from the sample, and (c) firms that are in the process of merger, acquisition or joint venture are also excluded from the sample.

Table 4.2 shows the industry classification of sampled firms. The majority of the sampled firms are from three main sectors from industrial product, trading and services, and consumer products.

Table 4.2: Number of Observations by Industry

Industry Classification	Total Firms	Sample Firm Frequency	Number of Firm Year-Observation
Industrial Product	267	44	220
Trading and Services	179	39	195
Consumer Product	139	34	170
Properties	88	27	135
Plantation	41	16	80
Technology	31	10	50
Construction	54	15	75
Infrastructure	7	3	15
Hotel	5	1	5
Finance	20	20	100
Total	**831**	**209**	**1045**

Tables 4.3 and 4.4 below show the two phases of studies for this research. The first phase of the research categorizes the less regulated firms (LRFs) into three ownership structured groups: politically connected (PCON) firms (67), institutional ownership and managerial (INST&MGRL) ownership firms (54), and family (FAMILY) owned firms (68). The non-PCON firms are firms belonging to the categories INST&MGRL and FAMILY. The second phase categorises the samples into highly regulated firms (HRFs) (20) and less regulated firms (LRFs) (189). The highly regulated firms are firms classified in the finance industry.

Table 4.3: Total Sample Firms by Ownership Structured Groups

	Number of Firms
Politically Connected Firms	67
Institutional and Managerial Ownership Firms	54
Family Ownership Firms	68
	189

Table 4.4: Total Sample Firms by Industries

	Number of Firms
Highly Regulated Firms	20
Less Regulated Firms	189
	209

The PCON firms are identified from the studies of Johnson and Mitton (2003), Mohamad *et al.* (2006), Abdul Wahab *et al.* (2009 and 2011) as well as Khazanah Berhad web site (www.khazanah.com.my). However, firms which are listed in the said previous studies as PCONs but do not have complete data are excluded from this study. Similarly, financial firms are not included in the list of PCON firms.

Non-PCON firms are firms other than PCON firms. As discussed in Chapter 2, non-PCON firms are further categorised into institutional and managerial ownership firms, a family owned firms based on its ownership structure to provide a more comprehensive analysis. The ownership structures are identified based on the top five majority shareholders disclosed in the annual report (under the lists of 30 largest shareholders). The institutional ownership (INSTL) is measured using the proportion of shares owned by five largest investors to total number of shares issued (Abdul Wahab *et al.*, 2007; Hashim and Devi, 2008). The five largest institutional investors include Employee Provident Fund (EPF), Lembaga Tabung Angkatan Tentera (LTAT), Lembaga Tabung Haji (LTH), Social Security Organization (SOCSO) and Permodalan Nasional Berhad (PNB). Managerial Ownership (MGRL) is measured using percentage of shares held by independent non-executive directors, executive directors and non-independent non-executive directors (Hashim and Devi, 2008). Family ownership (FAMILY) is measured using the ratio of family members on the board to total number of directors (Haniffa and Cooke, 2002; Ghazali and Weetman, 2006; Hashim and Devi, 2008).

4.6 Research Models and Hypotheses Development

As mentioned in the introduction, the study entails two phases as one is set in a low regulatory environment and the other compares the two different regulatory regimes: the highly regulated and the less regulated. Thus, the hypotheses for the study are related to two models. Model 1 (see Figure 4.1) focuses on the moderating effect of political connections on the association between the internal governance mechanisms of audit committee characteristics and internal audit function attributes, and audit fees for PCON and non-PCON firms (H1 to H3). Model 2 (see Figure 4.2) examines the moderating effects of regulatory oversight on the association between the audit committee characteristics and internal audit function attributes, and audit fees for highly regulated firms and less regulated firms (H4 to H6).

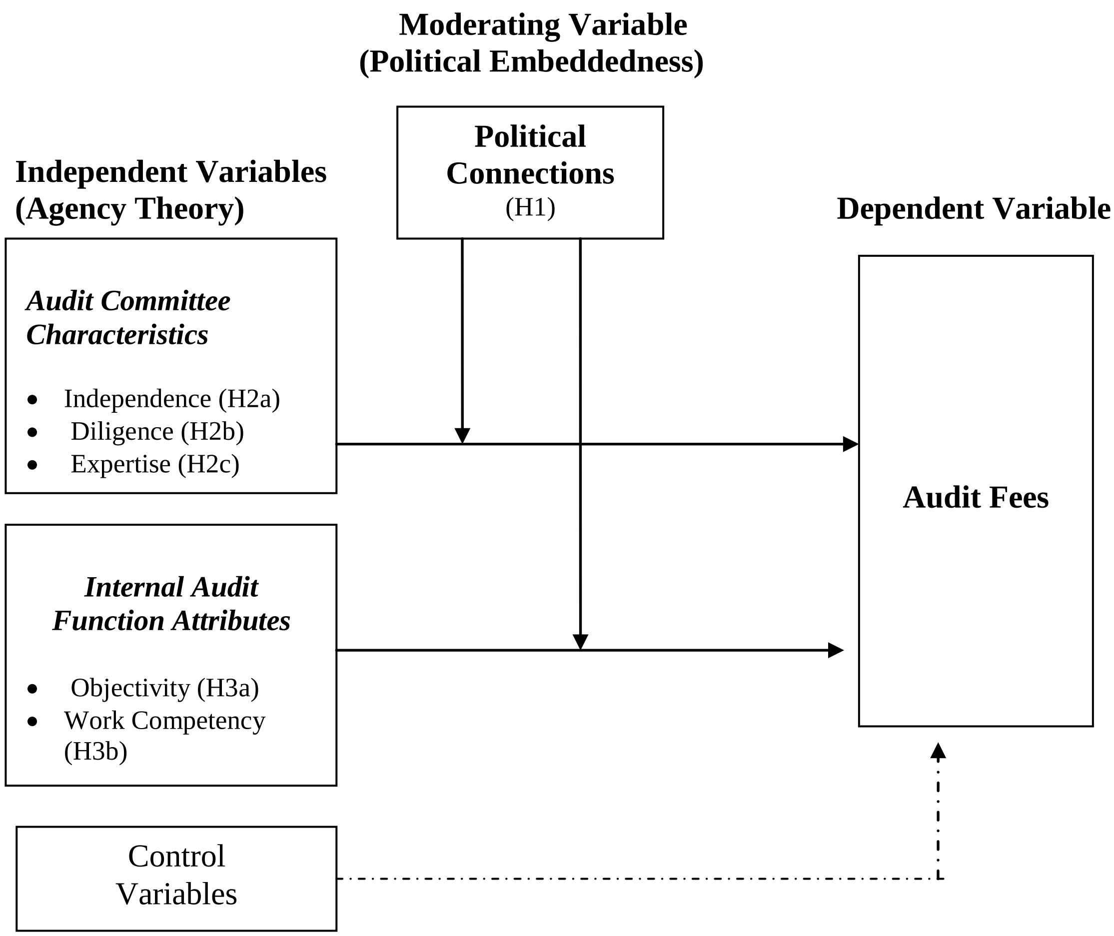

Figure 4.1: Research Model 1

4.6.1 Politically Connected (PCON) Firms and Audit Fees

In Malaysia, significant government equity holdings (Abdullah, 2006) and other types of ownership structures distinguish the ownership pattern of Malaysian firms that may complicate the corporate governance systems. According to Abdul Samad (2004), ownership structure is one of the important factors in determining the nature of agency cost in a governance system.

With regards to the role of institutional investors, Claessen and Fan (2002) find that such investors may improve corporate governance practices and alleviate the conflict of interests between controlling owners and minority shareholders in Asian firms. Their active role in monitoring the actions of management prevents managers' opportunistic behaviour (Wan Hussin and Ibrahim, 2003), and thus should reduce agency costs.

Further, Malaysia has a "relationship-based" economy resulting from the existence of PCON firms (Bliss and Gul, 2012). These PCON firms have exclusive business relationships with the state-owned enterprises and have the ability to access government's major contracts (Gomez and Jomo, 1999). Most interestingly, not many countries exhibit such corporate phenomenon among their listed firms. It is evidenced that, in the early stages of the Asian Financial Crisis, PCON firms were perceived by the market as being inefficient and that the government was unlikely to be able to support these favoured firms (Johnson and Mitton, 2003). Studies on PCON firms and Bumiputra-controlled firms (Johnson and Mitton, 2003; Gul, 2006; Yatim *et al.*, 2006; Eichenseher, 1995) argue that these favoured firms are generally perceived to be riskier than other types of ownership structured firms. They observed that PCON firms suffered the most during the early stages of the Asian Financial Crisis when the government was unable to implement capital controls. However, once capital controls[14] were imposed, the returns of these favoured firms were higher on average. It can thus, be concluded that favoured firms in Malaysia appear to be closely connected to influential political figures (Gul, 2006).

Since PCON firms are perceived to be riskier than non-PCON firms, it is reasonable to expect PCON firms to implement good governance system to improve the compliance level, consequently to protect their reputational capital. Furthermore, good governance practices help to reduce audit risk due to business failure or the likelihood of financial misreporting. Having good governance indicates demand for a substantive audit testing from auditors and to produce reliable financial statement audit. It will seen be in Section 6.4 of Chapter 6 that the findings from the interviews conducted in this current study (IA1, IA3, EA2 and EA3) also support the view that PCON firms adopt corporate governance reforms that enhance the quality of good corporate governance practice.

However, during the pre-2007 period, Gul (2006) finds a greater increase in audit fees for PCON firms than for other ownership structured firms, suggesting a supply-side explanation for audit fees. Abdul Wahab *et al.* (2009) find a positive relationship between institutional ownership and audit fees and they too found that the audit fees are higher for PCON firms during the pre-2007 period. No studies have been reported to date on the impact of the BMLR 2008 on audit fees for PCON and other ownership structured firms. Based on prior literature for pre-2007 period and the arguments presented above, we propose the following hypothesis:

[14] Government's implementation of capital controls in 1998 to benefit political-connected firms due to Asian financial crisis in 1997.

Hypothesis 1:
PCON firms pay higher audit fees than non-PCON firms.

4.6.2 Audit Committee Characteristics and Audit Fees

One implication which agency theory holds for understanding corporate governance is the role of an audit committee. Parker (1992, p.10) defines an audit committee as "*a committee appointed by a company as a liaison between the board of directors and the external auditors. The committee normally has a majority of independent non-executive directors and is expected to view the company's affairs in a detached and dispassionate manner".* An audit committee should have the characteristics of being independent, diligent and have financial or accounting expertise.

4.6.3 Audit Committee Independence

One of the important key characteristics of an audit committee's effectiveness is its independence from management (BRC, 1999; POB, 1993). As reported by the Blue Ribbon Committee (BRC, 1999; MCCG, 2007), independence is defined as having "*no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation*". Likewise, Goodwin and Yeow (2001, p.109) refer to independence "*as not having a relationship which would interfere with the exercise of independent judgement in carrying out the functions of the committee*".

The Bursa Malaysia Listing Requirements (BMLR) have not specifically defined independence but emphasized it in Para 15.10 (b). It requires all audit committee members to be non-executive directors with a majority of them being independent directors, and the chairman of the audit committee is an independent director. Comparatively, prior to the revision in 2008, the BMLR merely required a majority of the audit committee to be independent directors. Para 15.10 (b) of the new BMLR 2008 adopted the Securities Commission's recommendations for corporate governance that an audit committee should comprise all non-executive directors, a majority of whom are independent (BM, 2008).

Past literature has put forward the idea that an independent audit committee is an effective monitor as it is not part of the management and has no financial interest in the firm. This is because the board and audit committee are in place to monitor the management who otherwise may act in their best personal interests and not the interests of their principal (Fama and Jensen, 1983; Jensen and Meckling, 1976). Due to the separation of ownership and control, the agency theory also views managers as self-interested actors who could engage in opportunistic behaviour (Jensen and Meckling, 2007). The decision making process is delegated by shareholders to the managers, who are the executives. Due to managers pursuing their own interests, board and audit committee are involved in monitoring managerial decision-making and performance of the organization. A most common way to reduce agency costs is the provision for an independent party which is the board and audit committee, to monitor the agent (management) and report back to the owners who are the shareholders (Cohen *et al.,* 2008).

Since the accounting and auditing literature draws heavily upon the agency theory, a primary focus has been on the understanding of the impact of the independence of the board or audit committee or both on a number of financial reporting and auditing issues (Cohen *et al.*, 2008). For example, Rosenstein and Wyatt (1990) find that the appointment of outside directors was associated with positive abnormal returns in the stock market. In addition, firms that committed financial statement fraud were less likely to have a strong and independent audit committee (Abbott *et al.,* 2003; Beasley, 1996; Beasley *et al.,* 2000). Consistent with the risk-based approach, an independent audit committee leads to an effective audit committee oversight of the financial reporting process which reduces the incidence of financial reporting issues (Abbott *et al.,* 2004; BRC, 1999; Dechow *et al.*, 1996; McMullen, 1996). Thus, it is not surprising that Abbott *et al*. (2003) and Vafeas and Waegelein (2007) find that audit committee independence has a significant positive impact on audit fees when the audit committee is made up of either solely or a majority of independent members. It also lends support that an independent audit committee is connected with higher audit fees due to greater demand for audit quality in order to protect its members' reputation (Abbott and Parker, 2000; Carcello and Neal, 2000).

Bedard *et al.* (2004) also argue that higher director independence on audit committee provides more effective oversight of the financial reporting process. In order to protect the audit committee members' reputation capital, they will demand additional assurance from external auditors. Thus, this study expects that audit committee independence contributes to higher audit fees. It will be disclosed in Section 6.4 of Chapter 6 that PCON firms aim at enhancing corporate governance. Thus, it is hypothesized that their audit committees should be more independent and provides superior oversight over financial reporting process. As the firms require more extensive audit testing, higher external audit fees are expected. Therefore, the foregoing argument leads to the following hypothesis stated in an alternate form:

Hypothesis 2a:
The association between audit committee independence and audit fees is stronger post-BMLR 2008 implementation for PCON firms than non-PCON firms.

4.6.4 Audit Committee Diligence

Several independent advisory bodies have developed guidelines proposing the reform of both the audit process and the audit committee. One of the important guidelines of an audit committee is being diligent in carrying out their work. The Blue Ribbon Committee Report (1999) and the Treadway Commission (1987) recommended that the audit committee should have direct communication channels with the external auditor to discuss and review specific issues as appropriate.

Accordingly, the BMLR 2008 Para 15.18 (f) sets out the rights of an audit committee to convene meetings with the external auditors, the internal auditors or both, and exclude the attendance of other directors and employees whenever necessary. This is an improvement from the previous position whereby it was provided that the audit committee could convene meetings with the external auditors, excluding the attendance of the executive members of the committee.

It is noteworthy that the frequency of audit committee meeting is also found crucial by the National Association of Corporate Directors (NACD) (2000) which proposes that audit committee should meet at least four half-day in a year. Likewise, the ASX Corporate Governance Council (2010) recognises the need for the audit committee to meet regularly so as to effectively carry out their duties. In Malaysia, the MCCG (2007) best practices highlight that audit committees should meet at least four times in a year or once on a quarterly basis. Although BMLR 2008 did not specify the minimum number of audit committee meetings, Para 15.16 (3)(c) of the new Listing Requirements requires the disclosure in the audit committee report the number of meetings held during the financial year and the details of the attendance of each member of the audit committee. Further, the Blue Ribbon Committee (1999) contended that audit committees need to sacrifice their valuable time in executing their duties in order to be effective. This is consistent with Conger, Finegold and Lawler (1998) and Vafeas (1999) who suggest that board effectiveness depends on the number of meetings held annually as higher frequency of meetings increases board effectiveness (Vafeas, 1999) and signals its diligence (Menon and Williams, 1994).

Past studies and governance best practices called for audit committees to be diligent in carrying out their duties (Abbot, Parker and Peters, 2004). Further, according to Yatim *et al*. (2006), frequent audit committee meetings can reduce the tendency for financial reporting problems as they provide a forum for the audit committee and internal auditor to exchange relevant and important information and also allow the audit committee to notify the auditor of issues that require greater attention from the auditor (Raghunandan, Rama and Scarbrough, 1998).

As found by Kalbers and Fogarty (1998) and Goodwin and Kent (2006), audit committees that meet frequently are more likely to be better informed and more diligent in discharging their responsibilities. As such, it is reasonable to expect that audit committees who meet frequently will demonstrate greater diligence in performing their duties. Consequently, as supported by Yatim *et al.* (2006) external audit fees are positively and significantly related to the frequency of audit committee meetings. Studies by Carcello *et al.* (2002) and Abbott *et al.* (2003) which are consistent with the demand approach, argue that more diligent audit committee is likely to seek higher quality audits from external auditors, resulting in higher audit fees.

It will be disclosed in Section 6.3 of Chapter 6 that two of the respondents from the interviews conducted in this present study support that the frequency of audit committee meetings reveals much about the committee's effectiveness and diligence. These recommendations and requirements support the arguments that: (1) meeting frequency is an important element of audit effectiveness, and (2) meeting frequency is often used as a proxy for audit committee diligence.

From the extant literature review, we predict that more diligent audit committees would demand substantive audit testing by the external auditor which results in higher audit fees for PCON firms. This is due to the fact that the government has put much attention and initiatives to make sure that these firms always perform in an effective way. As a diligent audit committee is able to request for a substantive audit testing from the external auditor should any auditing issue arise, we predict that a diligent audit committee will result in higher audit fees. This supports prior research (Yatim *et al*., 2006; Carcello *et al*., 2002; and Abbott *et al*., 2003) which determined that a diligent audit committee will seek higher quality audits from the external auditor resulting in higher audit fees, and conjectures the next hypothesis.

Hypothesis 2b:
The association between audit committee diligence and audit fees is stronger post-BMLR 2008 implementation for PCON firms than non-PCON firms.

4.6.5 Audit Committee Expertise

In 1999, the Blue Ribbon Committee (BRC) gave ten recommendations concerning the effectiveness of audit committees. Amongst others is Recommendation 2 which relates to the audit committee expertise (BRC, 1999). According to Coates, Marais and Weil, (2007, p176), *"each member of the audit committee shall be financially literate, as such qualification is interpreted by the firm's Board of Directors in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee"*. An audit committee is expected to be financially literate and knowledgeable about technical auditing matters. This is because auditors are less likely to refer complicated auditing issues to an audit committee if they perceive the audit committee as less knowledgeable about technical auditing matters (Cohen *et al.*, 2002).

Further, even though the financial information which is pertinent to the evaluation of the firm's performance is prepared by the managers and has to be reviewed and attested by an independent party i.e. the external auditors, it is still necessary for the information to be reviewed by the audit committee. This is because one of the primary functions of an audit committee is to monitor and control the operation of a firm especially when it involves auditing. Thus, the expertise of the audit committee is crucial in understanding the audit work carried out by the external auditor.

Hence, in the 2007 Revised Malaysia Code of Corporate Governance (MCCG, 2007), it was recommended that all members of the audit committee should be able to read, analyze and interpret financial statements so that they will be able to effectively discharge their functions. Bursa Malaysia when revising its Listing Requirements did not adopt the recommendation fully. Instead it retained the regulation that at least one member of the audit committee has one of the following qualifications:

(a) a member of the Malaysian Institute of Accountants (MIA); or

(b) at least three (3) year's working experience and:-

    (i) have passed the examinations specified in Part 1 of the 1st Schedule to the Accountants Act 1967; or
    (ii) a member of one of the associations of accountants specified in Part II of the 1st Schedule to the Accountants Act 1967; or

(c) fulfils such other requirements as prescribed by the Exchange.

However, the BMLR 2008 Para 15.13 (e) spells out the function of the audit committee to include the review of the adequacy of the competency of the internal audit function. Additionally, Para 15.16 (3) (e) provides that the audit committee report shall include a summary of the activities of the internal audit function or activity. This is an improvement compared to the previous provision where the audit committee report should include the internal audit function only if there was such a function or activity. However, an explanation was required if such activity or function did not exist.

Having a financial expert on the board helps when reviewing the internal audit proposals (Read and Raghunandan, 2001) and investigating accounting irregularities. Moreover, past experience and knowledge in accounting and auditing enhance the accuracy of the investigation and produce better financial reporting quality. DeZoort and Salterio (2001) find that audit committee's professional judgments on auditor-management issues pertaining to accounting policy differed between those with and without accounting and auditing knowledge. As such, Sharma, Naiker and Lee (2009) reveal that audit committee accounting experts and independent directors play an important role in monitoring by demanding frequent audit committee meetings when management adopts aggressive accounting practices.

Further, Gendron and Bedard (2006) reveal that an audit committee who is financially literate is more effective in adhering to best practices, and to secure a high quality of reported earnings. Thus, the more number of experts there are in the audit committee, the better will be the monitoring and adherence to best practices.

According to Abbott *et al.* (2003), audit committee financial expertise has a significant positive impact on audit fees. Yatim *et al.* (2006) find a significant and positive association between audit committee expertise (proportion of audit committee members with accounting and finance qualifications) and audit fees. This is because a financially literate and knowledgeable audit committee will demand audit quality as the members are knowledgeable on technical auditing issues, and hence the increase in audit fees. This is supported by empirical evidence (Abbott *et al*,. 2003). As PCON firms are expected to adopt stronger governance which includes having an audit committee with financial expertise, it is hypothesized as follows:

Hypothesis 2c:
The association between audit committee expertise and audit fees is stronger post-BMLR 2008 implementation for PCON firms than non-PCON firms.

4.6.6 Internal Audit Function Attributes and Audit Fees

As discussed earlier, the role of internal audit function is important in the corporate governance structure. It assesses the firm's internal controls, examines the effectiveness and efficiency of the firm's operation and ensures compliance of policies and procedures. Hence, it is important for the internal auditors to maintain a close working relationship with the firm's audit committee so as to reduce material misstatements in financial reports (Treadway Commission, 1987). In order to obtain maximum benefit, the Blue Ribbon Committee (1999) recommends that open lines of communication should exist between internal audit and audit committee. Likewise, Para 15.18 (d) of BMLR (2008) states that audit committee must have direct communication channels with external and internal auditors. The interaction between internal audit function and audit committee in a variety of activities (Raghunadan *et al*., 1998) is important for the effectiveness of both parties. Further, section 404 of Sarbanes Oxley Act 2002 has expanded the role and duties of external auditor in evaluating and testing internal controls (Cohen *et al.*, 2008). Thus, it is important to study the association between internal audit functions and audit fees.

Following studies on internal control which used internal audit function as proxy, prior studies measure internal audit function by using internal audit expenditures, internal audit assistance, and ratio of internal audit costs to total costs, internal audit payroll and number of internal auditors (Hay *et al*., 2006). In addition, the size of the function is used to measure the IAF contribution. However, Prawitt *et al*. (2008) highlight that this measurement is closely related to the demand for auditing rather than the quality of IAF. Hence, this study proposes to use other measurement.

According to SAS No. 65, *the Auditor's Consideration of the Internal Audit Function of Financial Statements* (AICPA, 1997) describes that IAF quality characteristics comprised of competence (e.g. educational level, certification), objectivity (e.g. reporting relationship, group responsible for IAF employment) and quality of work performance (e.g. scope of work performed, adequacy of audit programs). The PCAOB, in Auditing Standard 5 (AS5), restates that external auditors should also base the reliance decision in these three areas (PCAOB, 2007).

Abdel-Khalik, Snowball and Wragge (1983) rank objectivity as the most significant factor in assessing the IAF. However, a study done by Grambling, Maletta, Arnold and Bryan (2004) show that quality of work performance is an important factor in assessing IAF quality as compared to objectivity and competence. This is consistent with Schneider (1984, 1985, and 1985) and Brown and Karan (1986), that the most important factor in evaluating IAF quality is work performance, followed by competence and objectivity. This is not surprising, for the external auditor will not rely on the work performed by the internal auditor unless it meets the minimum standard. As Al-Twaijry, Brierley and GWilliam (2004) conclude, the extent of reliance on the work of the internal auditor by an external auditor depends on the quality of work carried out by the internal audit department. An increase in internal audit contribution to external audit work results in overall audit coverage and improves audit quality (Mat Zain, 2005). Further, it permits the external auditor to log in fewer hours. However, as was found by many studies, the reliance on internal audit function does not lead to any reduction of audit fees (Mat Zain, 2005; Carey, Craswell and Simnett, 2000; Stein, Simunic and O'Keefe, 1994).

Following the discussion, Goodwin and Kent (2006) suggest a significant positive association between the existences of internal audit function and audit fees. Mat Zain (2005) finds that audit fees are not reduced even though the external auditors rely on the internal audit work, as the external auditors expand their time on examining more critical and important areas. Besides that, as it will be observed in Section 6.3 of Chapter 6, the interview findings (EA3, IA3 and R1) from the present study support the argument that greater reliance can be placed by the external auditors on the work of internal auditor provided that they are assured of the reliability of the information and the quality of internal audit function. However, it may not necessarily lead to a reduction in audit fees. This suggests that firms use internal audit as complementary rather than as a substitute to external audit. Additionally, audit fees are higher when firms use internal audit as complementary means of increasing overall monitoring (Hay *et al.*, 2006; Leung *et al.*, 2004). This is because directors and audit committee members may choose to increase investment in both internal and external auditing in order to protect their reputations (Knechel and Willekens, 2006).

In Malaysia, the MCCG (revised 2007) recognizes the importance of the internal audit function by recommending that firms carry out their own internal audit functions. Further, the amended BMLR 2008 (Para 15.28) mandates all listed firms to establish an internal audit function which is independent of the activities it audits and to report directly to the audit committee. Moreover, Appendix 9C (30) of the BMLR 2008 enhances disclosure in the annual report to include information pertaining to the activities carried out and the cost incurred for an internal audit function regardless of whether the internal audit function is performed in-house or is outsourced. Therefore, such expectations on the internal audit function to improve corporate governance and demand for further quality audit work would undoubtedly increase audit fees. Further, even though the external auditing standards permit the external auditors to rely on the work of internal auditors in performing a financial statement audit to the extent that the internal auditors are competent, objective and perform work that is relevant to the external audit (AICPA 1997; PCAOB 2007), it is anticipated that PCON audit members may still demand for audit quality. Thus, additional audit testing will lead to higher audit fees.

However, the focus in this study is only on the aspects of objectivity and work performance in this particular research due to the changes in BMLR 2008 on the internal audit function. The internal audit function quality is omitted due to non-availability of data. It is hypothesized that:

Hypothesis 3a:
The association between internal audit function attribute, namely objectivity and audit fees is stronger post-BMLR 2008 implementation for PCON firms than non-PCON firms.

Hypothesis 3b:
The association between internal audit function attribute, namely work performance and audit fees is stronger post-BMLR 2008 implementation for PCON firms than non-PCON firms.

4.7 Highly Regulated Firms (HRFs) and Audit Fees

Figure 4.2 presents Model 2 which examines the moderating effects of regulatory oversight on the association between the audit committee characteristics and internal audit function attributes, and audit fees for highly regulated firms and less regulated firms (H4 to H6). In Malaysia, the financial institutions and insurance firms are subject to the regular oversight by Bank Negara Malaysia. As discussed in Chapter 2, the BNM's supervision on these firms are extensive and thus they qualify as highly regulated firms for the purpose of this study. An issue is whether the regulatory oversight by BNM could impact the demand for additional assurance from the external auditor.

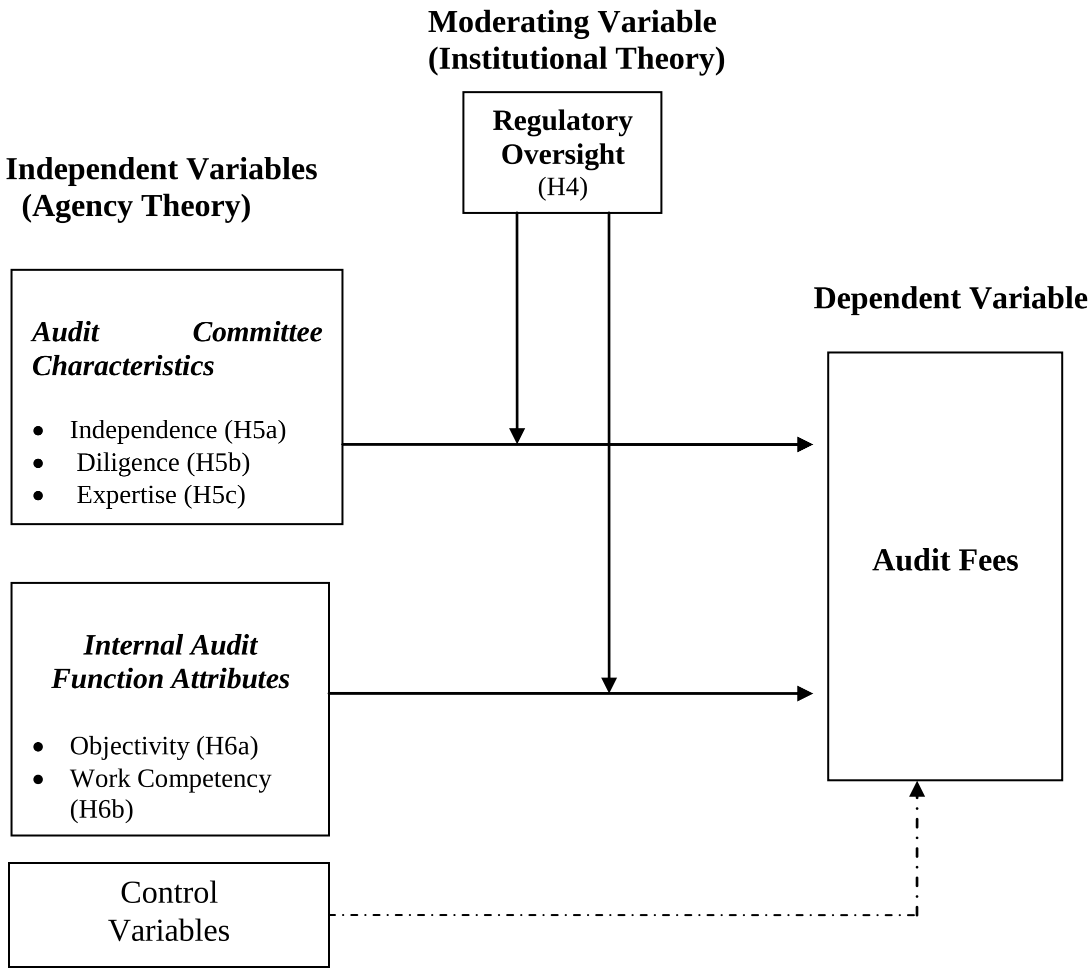

Figure 4.2: Research Model 2

Past literature suggests that effective regulatory oversight has an influence on firm's corporate governance. Bryan and Klein (2005) propose that direct monitoring by regulators decreases information asymmetries in regulated industries as compared to less regulated industries. They also argue that regulatory oversight provides close monitoring that eventually will reduce the role of external auditing as a control mechanism. By relying on the effective external and internal monitoring processes, auditors could reduce the extent of costly testing procedures in highly regulated firms. Therefore, effective regulation and oversight of regulators provide better incentives in a situation where directors with reputation capital at stake demand more extensive audit, resulting in higher audit fees.

Similarly, Boo and Sharma (2008) investigate regulatory oversight impact on internal corporate governance and audit fees for a sample of 469 large US highly regulated and less regulated firms. They find that regulatory oversight influences audit fees and the association between internal governance and audit fees. They attribute lower audit fees to highly regulated firms as compared to less regulated firms. This is due to close monitoring by industry-specific regulators which reduces information asymmetries and level of oversight required from corporate governance mechanism such as the board, audit committee and external auditor.

Hence, regulatory oversight has the potential to diminish the important role of corporate governance key players such as the board of directors and the audit committee. The greater vigilance and stronger internal control in response to close regulatory monitoring reduces the level of audit risk, which hinders the need for closer audit scrutiny. Corporate governance mechanisms such as board and audit committee do not require an extensive audit when there is regulatory oversight. Therefore, there will be lower audit effort and eventually lower audit fees for highly regulated firms than less regulated firms (Boo and Sharma, 2008).

Although Malaysia has a well developed set of regulations and rules related to corporate governance performance areas, it was rated among the lowest in the region in terms of enforcement (Miles, 2009). The reality is that, enforcement has been selective in the past and is perceived to be politically determined (Gul, 2006). This has provoked increased awareness about issues concerning the role of regulators and the need for improved disclosure and corporate governance. Due to the ineffective enforcement by regulators, it has brought to light instances of corporate abuses which are attributable in part to ineffective corporate governance structures.

In addition, Fields *et al.* (2004) find that high levels of litigation risk in highly regulated industries also affect the relationship between industry-specific regulated firms and their auditors. When the auditors are subject to extensive regulatory scrutiny, they are likely to charge higher audit fee due to the increased regulatory risks. According to Bedard *et al.* (2004), auditors will strategically respond to client risks through appropriate adjustments to the audit procedures. Auditors who observe higher client risks will increase their audit effort, resulting in higher audit fees. Therefore, the foregoing argument leads to the following hypothesis stated in an alternate form:

Hypothesis 4:
Highly regulated firms pay higher audit fees than less regulated firms.

4.7.1 Audit Committee Characteristics and Audit Fees

Regulators emphasize on the need for audit committees to comprise of members who are independent and at least one member should be financially literate. They also require audit committees to be diligent in carrying out their duties (BRC, 1999; NYSE, 2002; BMLR, 2008). The literature suggests that these characteristics impact the effectiveness of an audit committee (Beasley *et al.*, 2000; Carcello and Neal, 2000; Abbott *et al.*, 2004) because the audit committee plays an important role in monitoring the financial reporting process. As Vafeas (2007), Carcello (2009) and Goh (2009) find the board of directors and its sub-committees are important components of internal control mechanisms for monitoring management’s activities. The audit committee assists the board in fulfilling its responsibility by providing oversight with respect to financial statements and reports, and other disclosures provided to shareholders, as well as the system of internal controls and the audit process.

Further, prior studies by Carcello *et al.* (2002), Abbott *et al.* (2003), Knechel and Willekens (2006), and Goodwin and Kent (2006) suggest that audit committees who are independent, diligent and financially literate demand expanded audit scope in order to avoid being associated with financial misstatement and to preserve reputation capital. This is because investors, depositors and regulators have direct interest and are concerned with the performance of the firms. For that reason, audit committees in industry-specific regulated firms demand higher external audit monitoring and auditing services.

Thus, this study extends the literature by examining the impact of regulatory oversight on the association between audit committee characteristics (independence, diligence and expertise) and audit fees for highly regulated firms. This study predicts that the presence of efficient regulatory oversight and audit committee which is independent, diligent and has expert contributes to a better external and internal monitoring. This results in higher audit testing by external auditors, and hence higher audit fees. Consequently, the study predicts the following hypotheses:

Hypothesis 5a:
The association between audit committee independence and audit fees is stronger post-BMLR 2008 implementation for HRFs than LRFs.

Hypothesis 5b:
The association between audit committee diligence and audit fees is stronger post-BMLR 2008 implementation for HRFs than LRFs.

Hypothesis 5c:
The association between audit committee expertise and audit fees is stronger post-BMLR 2008 implementation for HRFs than LRFs.

4.7.2 Internal Audit Function (IAF) Attributes and Audit Fees

The Blue Ribbon Committee (1999) highlighted the importance of interaction between audit committee and internal audit to prevent material misstatement in financial reporting. Similarly, the Guidelines on Internal Audit Function for Directors of Public Listed Companies in Malaysia (IIA, 2000) have drawn attention to the need for close relationship between the audit committee and internal audit to contribute to the firm's success. Under the new listing requirements by Bursa Malaysia (2008), the internal audit department has a responsibility to report directly to the audit committee (objectivity). Consequently, the audit committee is required to review the internal audit activities, to the extent to which such activities are coordinated with the external audit program (work performance).

Past studies that examine the relationship between audit fees and the existence of internal audit find that audit fees are higher when firms use internal audit as a means of increasing overall monitoring (i.e. Goodwin and Kent, 2006). Additionally, greater vigilance and stronger internal control in response to close regulatory monitoring increases the need for closer audit scrutiny by the external auditor. Corporate governance mechanisms such as boards and audit committees demand for extensive audit when there is regulatory oversight. Hence, regulators play an important role as corporate governance key players.

The external auditing is likely to be influenced by the effectiveness of other internal corporate governance mechanisms. Better internal corporate governance implies that the control environment in the firm is more effective and financial statements are credible, hence influencing the external audit effort and audit fees. Abbott *et al.* (2003) posit that from the point of view of the audit committees, they demand a higher level of audit assurance, resulting in an increased level of audit coverage, and higher audit fees. Therefore, the changes in the IAF to improve corporate governance and demand for further quality audit work are expected to increase audit fees.

For that reason, this study extends the literature by examining the impact of regulatory oversight on the relationship between IAF attributes and audit fees for HRFs and LRFs. The study predicts that the presence of an efficient regulatory oversight and IAF attributes contribute to a better internal and external monitoring. This results in higher audit testing by external auditors, and hence higher audit fees. Therefore, the foregoing leads to the following hypotheses:

Hypothesis 6a:
The association between IAF attributes, namely objectivity and audit fees is stronger post-BMLR 2008 implementation for HRFs than LRFs.

Hypothesis 6b:
The association between IAF attributes, namely work performance and audit fees is stronger post-BMLR 2008 implementation for HRFs than LRFs.

4.8 Conclusion

This chapter discusses the research methodology and the research models underlying the hypotheses developed in this chapter and provide the definition and reasons for selecting the variables for both Models 1 and 2. Model 1 depicts the moderating effect of political connections (represented by PCON versus non-PCON firms) on the association between enhanced internal governance mechanisms of AC characteristics and IAF attributes and audit fees. Model 2 in turn examines the moderating effect of regulatory oversight (represented by HRFs and LRFs) on the association between the AC characteristics and IAF attributes, and audit fees.

This study applies the demand-based perspective to explain the audit fees phenomenon. The view taken is that the audit committee will demand greater audit procedures from the external auditor to safeguard their reputational capital, thus resulting in higher audit fees. It assumes that better AC characteristics and IAF attributes improve corporate governance. Further, this perspective assumes that stringent regulatory oversight improves corporate governance and increases audit fees due to demand for a greater level of responsibility on the part of the AC together with better quality of audit work by the external auditors. The next chapter will provide the research design of the study.

Chapter 5 RESEARCH DESIGN

5.1 Introduction

The previous chapter explained the framework of this study that incorporates three theories, namely the agency theory, political embeddedness perspective and institutional theory, and conjectured the hypotheses. Hence, by establishing key variables of interests and other potentially influential factors, it gives a better impression of the breadth of the problem of this study. This chapter discusses the research design for testing the hypotheses and measurement of the variables involved. This chapter also describes the sample selection and the semi-structured questions used during the interviews.

5.2 Model Specification

As mentioned in Chapter 4, there are two research models in this study, i.e. model one is in the context of a low regulatory environment, and in the second model, the highly regulated and less regulated firms are compared. Model 1 focuses on the moderating effect of political connections on the association between audit committee characteristics and internal audit function attributes, and audit fees. Model 2 examines the moderating effect of regulatory oversight on the association between the audit committee characteristics and internal audit function attributes, and audit fees.

5.2.1 Effects of Political Connections: Implication on Audit Fees

The first research model examines the moderating effects of political connections on the internal governance mechanisms of audit committee (AC) characteristics and internal audit function (IAF) attributes, and audit fees (PCON versus non-PCON). Drawing from

Craswell and Francis, (1999), Tsui *et al*. (2001), and Carcello *et al*. (2002), the following audit fee model is used to test Hypotheses 1, 2 and 3.

Model 1:

$$LAF = \beta_0 + \beta_1 TA + \beta_2 NAF + \beta_3 SUB + \beta_4 FOREIGN + \beta_5 SEG + ß_6 ROA + ß_7\ LEV + \beta_8 AQ + \beta_9 LOSS + \beta_{10} PRD + \beta_{11} PCON + \beta_{12} IND + \beta_{13} DIL + \beta_{14} EXP + \beta_{15} OBJ + \beta_{16} WP + \beta_{17}\mathbf{IND\_PCON} + \beta_{18}\mathbf{DIL\_PCON} + \boldsymbol{\beta_{19}}\mathbf{EXP\_PCON} + \boldsymbol{\beta_{20}}\mathbf{OBJ\_PCON} + \mathbf{WP\_PCON} + \varepsilon,$$

Where:

Hypotheses	**Dependent Variable**	**Exp Sign**	**Measurement of Variables**
	AF		Audit fees paid by the client (Natural logarithm of audit fees used in regression model).
AC Characteristics	**Experimental Variables**		**Measurement of Variables**
	IND	+	The proportion of independent non-executive directors to AC.
	DIL	+	Number of AC meetings.
	EXP	+	Number of AC with accounting or finance qualification.
IAF Attributes	**Experimental Variables**		**Measurement of Variables**
	OBJ	+	An indicator variable equals to '1' if the IAF reports directly to AC and '0' if otherwise.
	WP	+	Voluntary disclosure under IAF as per Para 43 of Statement of Internal Control (SIC)
	Control Variables		**Measurement of Variables**
	TA	+	Total assets for client at the end of fiscal year (Natural logarithm of TA).
	NAF	+	Total non-audit fee paid by client (Natural logarithm of NAF).
	SUB	+	Number of client's local subsidiaries.
	FOREIGN	+	Number of client's foreign subsidiaries.
	SEG	+	Number of business segments.
	LEV	-	Proportion of total liability over TA
	ROA	-	Profit before tax over TA.
	LOSS	+	An indicator variable equals to '1' if the firm has made loss in any of the periods and '0' if otherwise.
	PRD	+	An indicator variable equals to '1' for post-test period and '0' if otherwise.
	AQ	+	An indicator variable equals to '1' if the firm hires Big4 auditor and '0' if otherwise.

Hypothesis 1	PCON	+	An indicator variable, '1' for PCON firms and '0' if otherwise.
Hypothesis 2a	IND_PCON		Interaction between IND and PCON
Hypothesis 2b	DIL_PCON		Interaction between DIL and PCON
Hypothesis 2c	EXP_PCON		Interaction between EXP and PCON
Hypothesis 3a	OBJ_PCON		Interaction between OBJ and PCON
Hypothesis 3b	WP_PCON		Interaction between WP and PCON

5.2.2 Audit Fees

The dependent variable of audit fees is measured by the Ringgit Malaysia (RM) value of the audit fee paid by the firm to its auditors. Similar with the law in other British Commonwealth countries, the Companies Act 1965 of Malaysia also requires firms to disclose their statutory audit and non-statutory audit fees under notes to accounts in the firms' annual reports. A substantial penalty will be charged for none or inaccurate disclosure (Che-Ahmad and Houghton, 2001). For the purpose of this study, data on the sample firms' statutory audit fees were extracted and reclassified as audit fees. Consistent with previous studies (Francis, 1984; Francis and Simon, 1987), the following tests of normality, logarithmic transformation are applied to the audit fees.

5.2.3 Control variables

Audit fees models employed in past research have used a variety of variables to control sectional differences which are primarily influenced by size, complexity and risk of the audit client (Simunic, 1980; Craswell, 1992; Gul and Tsui, 1997; Francis, 1984; Chan *et al.*, 1993). The set of control variables selected in this study is consistent with the variables generally identified in much of the literature on audit fees (Hay *et al.*, 2006; Hay, 2012). These empirical models have demonstrated good explanatory power and have been used across different samples and different time periods (Mat Zain, 2005). Thus, the following control variables are also included in analyzing the enhanced internal governance mechanisms of audit committee characteristics and internal audit function attributes, and their implications on audit fees for PCON and non-PCON firms.

Prior studies have found that the most significant determinant of audit fees is the size of the auditee, which is usually measured by total assets (TA) (Craswell, 1992; Palmrose, 1986; Simunic, 1980; Turpen, 1990). A positive relationship between firm size and audit fees is predicted since larger firms are more complex and require more audit effort, hence higher audit fees (Simunic, 1980; Francis, 1984).

Further, the number of local subsidiaries (SUB), number of foreign subsidiaries (FOREIGN) and business segments (SEG) have been previously used to control for audit complexity (Simunic, 1980; Hackenbrack and Knechel, 1997), and hence they are taken into account in this study. This is because more subsidiaries and business segments will lead to greater amount of work and audit hours of consolidating and eliminating intra-group transactions (Chan *et al.,* 1993; Pong and Whittington, 1994).

As profitability has also been argued to influence audit fees (Chan *et al.,* 1993), return on assets (ROA) is measured by dividing the profit before tax over total assets and a negative relationship between ROA and audit fees is predicted. It is considered another measure of risk because it reflects the extent to which the auditor may be exposed to loss in a situation where the client is not financially strong (Simunic, 1980). In addition, a dummy variable for loss-making (LOSS) in any of the years is included and a positive relationship is predicted. This is because the risk is higher to the external auditors if the firm is under performing and thus, higher audit fee is expected. In addition, Zmijewski score (ZFC)[15] is computed for each firm to control for financial crisis (Model 2).

Past studies also argued that leverage (LEV) will also affect audit fees. The ratio of total liability to total assets is used to control for leverage which potentially exposes the auditor to risk if the client fails (Simunic, 1980). It is expected that the association between fees and leverage ratio is negative. Non-audit fees (NAF) are also included as a control variable because it is significantly associated with audit fees (Whisenant, Sankaraguruswamy and Raghunandan, 2003; Hay *et al.*, 2006). Prior studies have found that in certain circumstances, a fee premium exists for Big Eight/Six/Five/Four audit firms (Simon and Francis, 1998; Francis and Simon, 1987; Francis and Strokes, 1986). It is usually assumed the Big Eight/Six/Five/Four audit firms perform higher quality audit and charge higher audit fees (DeAngelo, 1981; Collier and Gregory, 1996; Palmrose, 1989). Therefore, a dummy variable for Big4 controls for differences in audit quality (AQ) (Craswell and Francis, 1999; Tsui *et al.* 2001) and it is expected that client firms of Big4 purchase a higher level of audit quality.

An indicator variable equals to '1' if PCON firms and '0' if otherwise is tested in Model 1. Post-test period (PRD) take a value of '1' and '0' if otherwise. Finally, a dummy variable take a value of '1' and '0' if otherwise for Regulated (REG) is incorporated to control for financial firms in Model 2.

[15] Zmijewski financial distress score: The model incorporates three weighted financial ratios taken from Zmijewski (1984).

1. Net income/Total assets (X_1)
2. Total debt/Total assets (X_2)
3. Current assets/Current liability (X_3)

The above ratios are used to compute the Zmijewski score using the following model:

$Z = 4.3 – 4.5\ X_1 + 5.7\ X_2 - 0.004\ X_3$

5.2.4 Experimental Variables

The experimental variables in this study are the internal governance mechanisms of audit committee characteristics and internal audit function attributes. They are discussed below.

5.2.5 Audit Committee (AC) Characteristics

The variables for audit committee characteristics are independence, diligence and expertise. The measurements for the respective characteristics are stated below.

5.2.5.1 Audit Committee Independence

An independent audit committee is likely to result in an effective oversight and is able to protect the reliability of the financial reporting process, hence reduce the incidence of financial reporting problems (Dechow *et al.,* 1996; Abbott *et al.,* 2004; BRC, 1999). According to Abbott *et al*. (2003), firms with audit committee members who are independent, meet frequently (diligent) and have financial expertise are less likely to experience material misstatement in financial reporting. The audit committee independence (IND) is measured by the proportion of independent non-executive directors in the audit committee (Balachandran, 2007; Goodwin *et al*., 2006; Yatim *et al*., 2006).

5.2.5.2 Audit Committee Diligence

The measurement of the variable audit committee diligence (DIL) is based on that used in previous studies such as Abbott *et al*. (2003), Goodwin and Kent (2006), and Yatim *et al*. (2006). DIL is measured using the number of meetings held annually. Prior research suggests that an audit committee that meets frequently can reduce the incidence of financial reporting problems. By meeting and communicating frequently, the audit committee is able to alert the external auditor on issues that require immediate attention from them (Raghunandan *et al.,* 1998).

5.2.5.3 Audit Committee Expertise

The effectiveness of an audit committee is further enhanced if members of an audit committee possess accounting and financial expertise. Bursa Malaysia mandates that audit committee members of listed firms should comprised of at least three members and at least one member must have the prescribed financial or accounting qualification. Empirical findings also support the assertion that an audit committee should at least consist of one member with accounting and financial expertise. This is because it allows for better understanding of auditing issues and risks (DeZoort and Salterio, 2001) and a firm with financial or accounting expert in its audit committee is less likely to experience restatement of earnings (Abbott *et al.,* 2003). Thus, in this study the audit committee expertise is measured by the number of audit committee members with accounting or finance qualification (Gendron and Bedard, 2006).

5.2.6 Internal Audit Function (IAF) Attributes

Past research on internal audit reliance (Brown, 1983; Margheim, 1986; Messier and Schneider, 1988; Schneider, 1984 and 1985; Abdel Khalik *et al.,* 1983; Edge and Farley, 1991) adopts SAS No.9[16], which requires external auditors to evaluate internal audit competence, objectivity and work performance when making a reliance decision. These studies focused on identifying the relative importance that external auditors place on the

[16] Statement of Auditing (SAS) No. 9 is now known as SAS No. 65

three previously mentioned factors in their assessment of the strength of the audit client's internal audit function.

In fact, SAS No. 65, *Auditor's Consideration of the Internal Audit Function of Financial Statements* provides external auditors with a framework in evaluating the audit client firm's characteristics of the IAF to determine the extent of possible reliance on the internal auditor's work. Importance is placed on the characteristics of IAF in terms of work performance, competence and objectivity (AICPA, 1997). Previous research has been done to determine whether external auditors rely on the work of IAF and whether the level of reliance is increased depending on the competence, objectivity and relevance of work performed by the internal auditors (Gramling, Maletta, Schneider and Church, 2004). In SAS No 65, the IAF quality characteristics comprised of competency (e.g. educational level, certification), objectivity (e.g. reporting relationship, group responsible for IAF employment) and quality of work performance (e.g. scope of work performed, adequacy of audit programs).

However, it is observed that the Malaysian Institute of Accountants (MIA) internal auditing guidelines (ISA 610, *International Standard on Auditing using the work of internal auditor's*) require external auditors to obtain an understanding of their internal auditing to make a preliminary assessment of its effects in determining external audit procedures. The ISA 610 guidelines encourage the external auditor to utilise internal auditors' work only if it has been assessed as reliable. Specifically, the reliability of the internal audit function is assessed based on objectivity, technical competence, due professional care and communication.

Nevertheless, instead of adopting the measurement prescribed by the MIA ISA 610 for internal audit function attributes this study adopts the measurements prescribed in the SAS No. 65 (AICPA, 1997). This is because there is no available data to measure the factors under the ISA 610 (i.e. technical competence, due professional care and communication). In addition, this study also follows past research by Mat Zain, (2005) and Haron, Chambers, Ramsi and Ismail (2004) which used SAS No. 65 for Malaysian data. However, only objectivity and work performance are applied in this research since there is no available data to measure the competency of the IA function.

5.2.6.1 Internal Audit Function - Objectivity

To measure objectivity, this study uses a binary measure of whether the head of the internal audit reports directly to the audit committee. If the head of internal audit function reports functionally to audit committee then value '1' is assigned and if it is to somebody else, then '0' is assigned (Prawitt *et al*., 2008).

5.2.6.2 Internal Audit Function - Work Performance

As for the quality of work performed by the IAF, SAS No. 65 specifies two different dimensions for examining the work performed by the IAF. First, by examining whether the work performed by the internal auditors is relevant to the financial statement audit and secondly, by examining the quality and effectiveness of the internal auditor's work. Since this study uses archival data, the latter measurement is unavailable. Therefore, it will focus on the first measure. This can be done in two ways that are: (1) to determine whether the internal auditor provides any assistance in completing the external audit work; and (2) to determine the activities performed by the internal auditors during the year which the external auditor can rely upon (Prawitt *et al*., 2008).

In this study, the IAF activities performed during the year are used as proxy for the work performed by the IAF is relevant to the external audit, for this information is publicly available. Para 15.16 (3) of the BMLR 2008 requires the information pertaining to the IAF activities to be disclosed in the audit committee report. Further, Para 43 of the *Statement of Internal Control* (SIC) provides for voluntary disclosures on internal audit function activities. Para 43 states that the board may wish to provide any additional information in the annual report to assist understanding of the firm risk management processes and system of internal control. This suggests that disclosures in excess of the minimum disclosure items are a way of signalling to shareholders of the firm's commitment to maintain an effective internal control (Haron *et al*., 2009). In this study, the number of IAF activities voluntarily disclosed in the audit committee report is collected and compared against a total number of 19 voluntary disclosure as stated in Para 43, as shown in Table 5.1 below.

Table 5.1: Measurement for Work Performance

	Internal Audit Function Activities
1)	Statements disclosing IAF activities.
2)	Describing the nature of re-sourcing of the IAF.
3)	Internal Audit Plan was based on annual risk assessment.
4)	Disclosing support of the IAF from the AC and the board.
5)	Direct reporting relationship to the committee.
6)	Disclosing that the internal audit charter was approved by the AC.
7)	Statements disclosing regular meetings with the head of IAF without the presence of management.
8)	Describing that the IAF provide reasonable assurance opinion to the board on the state of internal control.
9)	Discussing that the scope of the IAF includes control, risk assessment and governance processes.
10)	Describing the timely reporting of control weaknesses to the AC and management
11)	Disclosing that audit reports were issued to the right audience.
12)	Statements disclosing that internal audit observations were acted upon.
13)	Describing the provision of advisory services by the IAF.
14)	Disclosures on open lines of communication with AC and management.
15)	Describing that the AC decides on the hiring, remuneration and firing of the head of the IAF.
16)	Disclosures that the IAF is adequately staff.
17)	Statements disclosing that internal auditors possess the appropriate level of expertise and qualifications.
18)	Describing the existence of quality assurance of the performance of the IAF.
19)	Statements disclosing that the audit conducted by the IAF is in accordance with Internal Standards for the professional practice of Internal Auditing.

Source: Haron, Ibrahim, Jeyaraman and Chye (2009)

5.3 Effects of Regulatory Oversight: Implication on Audit Fees

We extend the above audit fees model by including the regulatory oversight (REG) as a moderating variable. For the audit fees, Model 2 is used to test Hypotheses 4, 5 and 6 and is represented in the equation below. This model was also adapted from the basic audit fee model by Simunic (1980).

Model 2:

$$AF = \beta_0 + \beta_1 TA + \beta_2 NAF + \beta_3 SUB + \beta_4 FOREIGN + \beta_5 SEG + \beta_6 ZFC + \beta_7 LEV + \beta_8 ROA + \beta_9 LOSS + \beta_{10} PRD + \beta_{11} AQ + \beta_{12} REG + \beta_{13} IND + \beta_{14} DIL + \beta_{15} EXP + \beta_{16} OBJ + \beta_{17} WP + \boldsymbol{\beta_{18} IND\_REG} + \boldsymbol{\beta_{19} DIL\_REG} + \boldsymbol{\beta_{20} EXP\_REG} + \boldsymbol{\beta_{21} OBJ\_REG} + \boldsymbol{\beta_{22} WP\_REG} + \varepsilon,$$

Where:

Hypotheses	**Dependent Variable**	**Exp Sign**	**Measurement of Variables**
	AF		Audit fees paid by the client (Natural logarithm of audit fees).
AC Characteristics	**Experimental Variables**		**Measurement of Variables**
	IND	+	The proportion of independent non-executive directors to AC.
	DIL	+	Number of AC meetings.
	EXP	+	Number of AC members with accounting or finance qualification.
IAF Attributes	**Experimental Variables**		**Measurement of Variables**
	OBJ	+	An indicator variable equals to ‘1’ if the IAF reports directly to AC and ‘0’ if otherwise.
	WP	+	Voluntary disclosure under IAF as per Para 43 of Statement of Internal Control (SIC).
	Control Variables		**Measurement of Variables**
	TA	+	The total assets (in RM) (Natural logarithm of TA).
	NAF	+	The non-audit fees (in RM) (Natural logarithm of NAF).
	SUB	+	The number of local subsidiaries.
	FOREIGN	+	The number of foreign subsidiaries.
	SEG	+	The number of business segments.
	ZFC	+	The Zmijewski scores for financial crisis.
	LEV	-	Proportion of total liability over TA.
	ROA	-	Profit before tax over TA.
	LOSS	+	An indicator variable equals to ‘1’ if the firm has made a loss in any of the periods and ‘0’ if otherwise.
	PRD	+	An indicator variable equals to ‘1’ for post-test period and ‘0’ if otherwise.
	AQ	+	An indicator variable equals to ‘1’ if the firm hires Big4 auditor and ‘0’ if otherwise.
Hypothesis 4	REG	+	As an indicator variable, ‘1’ for REGULATED, and ‘0’ if otherwise.
Hypothesis 5a	IND_REG	+	Interaction between IND and REG
Hypothesis 5b	DIL_REG	+	Interaction between DIL and REG
Hypothesis 5c	EXP_REG	+	Interaction between EXP and REG
Hypothesis 6a	OBJ_REG	+	Interaction between OBJ and REG
Hypothesis 6b	WP_REG	+	Interaction between WP and REG

5.3.1 Moderating Effects of Regulatory Oversight

The purpose of Model 2 is to test the moderating effects of regulatory oversight on the association between the internal governance mechanisms of audit committee (AC) characteristics and internal audit function (IAF) attributes, and audit fees for high regulated firms. The moderating variable, REG, is set to '1' for highly regulated firms and '0' if otherwise. On the assumption that regulatory oversight has a complementary effect on external auditing, the study posits that the extensiveness of the external audit is higher in highly regulated firms with stronger corporate governance than in less regulated firms. Under the quantitative method of analysis, regressions are used to describe the strength and direction of the linear relationship between AC characteristics and IAF attributes with audit fees. Linear regressions are used to test the moderating effect of regulatory oversight on the association between the internal governance mechanisms of AC characteristics and IAF attributes, and audit fees. In order to test the internal governance mechanisms on audit fees and in comparing between highly regulated and less regulated firms, t-tests analysis is conducted to further extend the basic findings.

5.4 Conclusion

This chapter provides the basis and reasoning for selecting the variables to be tested in the hypotheses based on audit committee (AC) characteristics and internal audit function (IAF) attributes. This chapter also gives an overview of the quantitative approach used in Phase 2 of this study. The next chapter will discuss the findings from the interviews with selected regulators, head of internal auditors and external auditors.

Chapter 6 PHASE 1: INTERVIEW FINDINGS AND DISCUSSIONS

6.1 Introduction

The main objective of this chapter is to present the results of Phase 1 of this study which involved a series of interviews with two (2) regulators (R1 and R2), three (3) heads of internal auditors (IA1, IA2 and IA3) and three (3) external auditors (EA1, EA2 and EA3). The aim of the interviews is to shed further light on the inter-relationships between regulators, internal auditors and external auditors and its implications on audit fees, and to develop the research questions and hypotheses.

6.2 Interview Findings

In the next section, the findings from the semi-structured interviews are discussed under three (3) main themes. First, the interviews gathered the perception of the selected respondents on whether the revised Bursa Malaysia Listing Requirements (BMLR, 2008) on audit committee characteristics (AC) and internal audit function (IAF) attributes have an impact on the audit fees. Secondly, the interviews focused on investigating the interviewee's perceptions on the effect of the enhanced listing requirements and audit fees for different types of ownership structured firms in Malaysia, specifically on PCON firms. Thirdly, the interviews centred on explicating the moderating effect of regulatory oversights on the association between audit committee characteristics (AC) and internal audit function (IAF) attributes, with audit fees for high regulated firms and less regulated firms.

Of the respondents who participated in the interviews, six (6) were males and two (2) were females. All eight (8) respondents have accounting qualifications and six (6) of them also held professional qualifications. Two (2) of the participants were members of the Institute of Internal Auditors Malaysia (IIAM) and four (4) were also members of the Malaysian Institute of Accountants (MIA). The respondents reported having at least six (6) years experience in the accounting and auditing field. The data matrix framework as provided in Table 6.1 below compares and contrasts the perception of the internal auditors, external auditors and regulators on the internal governance mechanisms, regulatory oversight and audit fees. The interview guide which is found in Appendix C was given to the respondents prior to the interview. Their responses are discussed below.

6.3 Perceptions on the Internal Governance Mechanisms and Audit Fees

In this section, the focus of the interviews was on the perceptions of the interviewees in terms of the enhanced BMLR 2008 on audit committee (AC) characteristics and internal audit function (IAF) attributes, and its implications on audit fees.

Audit committee is as an important self-regulatory governance mechanism with significant oversight responsibilities over financial reporting, internal control and audit activities (BRC, 1999; SEC, 1999; United States Congress, 2002). To ensure that audit committee serves as an effective check on the management of a company, the BMLR 2008 spells out the composition of an audit committee, the frequency of meetings and the need for audit committee members to attend continuous training to keep abreast with developments in relevant financial and other related developments. In addition, executive directors can no longer be a member of the audit committee in order to preserve the independence of the committee.

Thus, more research needs to be conducted to understand the impact of BMLR 2008 on audit fees. This present study interviewed eight (8) respondents, i.e. three (3) internal auditors, three (3) external auditors and two (2) regulators to get their perceptions on this. Interestingly, all eight (8) respondents[17] concurred that the BMLR 2008 has improved the role of audit committee and internal audit function in the governance of a listed firm. This is consistent with Cohen *et al.* (2002) that corporate governance developments have increased the focus on internal control systems, and the internal audit function has been identified as a key role in assessing and improving the quality of such system. Further, the audit committee plays a crucial role in improving the firm's internal controls through its monitoring of the work of internal and external auditors (Collier, 1992). Thus, it is anticipated that internal controls are stronger in firms which have an effective and efficient audit committee as noted by interviewee IA3:

> Audit committee involvement towards internal audit activities was not critical before, as they were looking only at reports. But now they are very much involved and the interaction between audit committee and head of internal auditors is good. As per last year, the company had seven or eight audit committee meetings and we even had a meeting without the presence of the management.

IA1 noting a similar viewpoint, states that:

> Corporate governance in Malaysia is good and will be better due to the support from Bursa Malaysia. Compared to previous years, a lot of differences have taken place especially in 2008 due to the additional roles of audit committee and internal audit function.

[17] Respondents for the interview in the current study are categorized as Internal Auditors (IA), External Auditors (EA) and Regulators (R).

Table 6.1: The Structured Interviews Data Matrix

	IA1	**IA2**	**IA3**	**EA1**	**EA2**	**EA3**	**R1**	**R2**
<u>Demographic Details</u>								
Age group	36-40	46-50	41-45	36-40	46-50	36-40	46 – 50	36-40
Gender	Male	Male	Male	Female	Male	Female	Male	Male
Professional Qualification/ Membership	IIAM/ ICSA	IIAM/ CIA	MIA	MIA	MIA/ CPA AUST	MICPA	MIA/ CPA AUST	CISA/ ISACA
No. of years working experience	>11 Years	>11 Years	>11 Years	>11 Years	>11 Years	6–10 Years	>11 Years	>11 Years
<u>Content Theme</u>								
A) Perceptions on the enhanced CG on AC characteristics and IAF attributes and AF implications.								
The revision BMLR 2008/09 affecting the role of AC.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
The revision BMLR 2008/09 affecting the role of IA.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Role of AC and IA	Very Effective	Very Effective	Effective	Effective	Effective	Effective	Very Effective	Very Effective
The revision on the role of AC and IAF contributes to the preparation of financial statement audit.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
External auditor still needs to conduct substantive audit testing.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

	IA1	IA2	IA3	EA1	EA2	EA3	R1	R2
Does the contribution of the IA assist in reducing external audit fees.	No	No	No	Yes	No	No	No	Yes
Audit fee is lowest in the region.	Agree	Agree	Agree	Agree	Agree	Agree	Agree	Agree
B) Perceptions on the enhanced CG for different types of ownership structure, specifically on PCON firms and audit fees implications.								
PCON firms are perceived to have poor corporate governance and riskier than non-PCON firms.	No	No	Yes	Yes	No	No	No	No
The enhanced CG on AC and IAF attribute affecting PCON the most. (H2, H3)	No	No	Not sure	No	Not sure	No	No	No
Most of the PCON firms have complied with the BMLR 2008 even before it became mandatory.	Agree	Agree	Not sure	Agree	Not sure	Agree	Agree	Agree
C) Perceptions on the regulatory oversights for high regulated and less regulated firms and its implications on audit fees.								
HRFs are more governed than LRFs.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
HRFs pay higher audit fees than LRS. (H4)	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes
The role of regulatory oversight. (H5, H6)	Very Effective	Very Effective	Effective	Very Effective	Very Effective	Very Effective	Very Effective	Very Effective
Most of the HRFs have complied with the BMLR 2008 even before it became mandatory.	Agree	Agree	Agree	Agree	Agree	Agree	Agree	Agree

Hence, the new requirements by the Bursa Malaysia further strengthen the role and responsibilities of an audit committee vis-a-vis the internal audit function, such as reviewing the adequacy, functions, competency and resources of internal audit and other audit activities. The audit committee has the ability to enhance the effectiveness of the internal audit function, and this in turn has implications for internal auditors' contribution to external audit work.

All eight (8) respondents agreed that the internal audit function contributes to the financial statement audit. The internal auditors provided reasonable assistance to their external auditors in areas that needed clarifications but they are not directly involved in the preparation of the financial statement. However, they did provide assistance to their external auditors during the course of the audit through various ways including getting more information about internal control systems in the organization. Normally, external auditors will review the internal auditors' work and if the work of the internal auditors is of reasonable quality, they tend to use the work completed by the internal auditors, particularly in areas such as internal control reviews.

The internal audit function also contributes to the financial statement audit. This was confirmed by the respondents who were interviewed in this present study. They affirmed that internal auditors do contribute towards the preparation of financial statements even though they are not directly involved. The internal auditors provide reasonable assistance to the external auditors in areas that need clarifications during the course of the audit exercise. In addition, the internal auditor may supply information about the firm's internal control systems. Further, external auditors review the internal auditors' work and if the work of the internal auditors is of reasonable quality, they tend to use the work completed by the internal auditors, particularly in areas such as internal control reviews.

Notwithstanding the role played by the internal auditors, most respondents when queried whether such assistance rendered by the internal auditors have any impact on audit fees, claimed that the contribution of the internal audit does not result in a reduction in the external audit fees. This is because external auditors tend to cover areas which are not fully covered by the internal auditors.

Further, as one of the respondents (IA3) said:

> External auditor does not fully rely on internal auditors report but they will drop by at the internal audit department to get information that they will use in doing the audit. External auditor only relies on controls but not financial matters because they have to be assured and need to do their own verification and testing.

Nevertheless, there are respondents who believed otherwise. For instance, EA2 said that the amount of audit fees charged is usually fixed and agreed upon before the external auditor's appointed. However, as audit fees are charged based on audit hours and number of staff assigned to audit the audited client, the fixed fees charged can be lowered if the number of audit hours and auditors are reduced. Thus, if the external auditors can rely on the internal audit work, the audit fees can be reduced. However, before the external auditors rely on the internal audit, they must be assured that the information is reliable and the internal audit function is of high quality.

According to one of the respondents (EA3) interviewed by the researcher:

> If the internal audit standards are met, the reliance on IAF can be in full, but if the firm does not meet the standards, we can rely to

> certain extend but not to reduce our work. It can reduce the audit effort but not that much.

Further, respondent R1 commented that:

> External auditors do not rely on internal audit function because they need to give their own opinion on how internal control and governance mechanisms are operating in the company. Reliance does not absorb them from responsibilities. Good corporate governance may reduce audit work to a certain extend because they need to focus on areas that are not being covered. External auditors need to assess and review the internal audit function before they can put some reliance.

Interestingly, findings indicate that the greater the objectivity, technical competence and quality of work performance, the larger the potential for internal auditors to contribute to the external audit (Krishnamoorty, Wright and Cohen, 2002).

Additionally, audit fees also depend on the level of substantive testing required (Sherer and Turley, 1991). The external auditors do cover areas which are not included in the internal audit work. Though the external auditor may rely on internal audit work and reduce the substantive testing resulting in lower audit fees, the external auditor cannot do so if compliance tests indicate that internal controls are not operating properly. Further, Devi and Samujh (2010) find that Malaysia's audit fees are still the lowest in the ASEAN region and this might be a reason for no reduction of audit fees despite reliance by the external auditor on the audited clients' internal audit function.

This is supported by the respondent (IA1) interviewed in this current study which claimed that:

> With the changes in regulation, the role and responsibilities of the audit committee and internal audit function are more, external

> auditors can rely on the job function of audit committee and internal audit function; however, the amount of audit fees charged would not be reduced but keep on increasing every year. This is because audit fees in Malaysia are the lowest in the region.

Likewise, another respondent (EA3) in this study also highlighted that:

> In Indonesia, audit fees are paid in US dollar unlike in Malaysia. Our audit fees are the lowest in the region and it will never reduce because the work and effort that we have to put in is great.

6.4 Perceptions on the Internal Governance Mechanisms and Audit Fees for PCON firms

Prior studies have shown that the presence of government ownership gives rise to inefficiencies and poor performance (Megginson, Nash and Randenborgh, 1994; and Megginson and Netter, 2001: Johnson and Mitton, 2003) to the government favoured firms. According to Mak and Li (2001), the government is likely to be less active in monitoring their investments in these firms. As a result, weaker accountability for financial performance, easier access to financing, lack of exposure to a market for corporate control, and weaker monitoring by shareholders are likely to reduce the incentives for PCON firms to adopt strong governance.

In addition, Gul (2006) evidenced that favoured firms in Malaysia are closely connected to influential political figures. His study documents evidence of ‘crony-capitalism’ in Malaysia. The favoured firms’ political linkages influence the accumulation and concentration of wealth in Malaysian business (Gomez and Jomo, 1999). However, despite the close connection with the influential politicians, the favoured firms are conscious of good governance.

From the interviews conducted in this current study, one of the interviewee (IA3) explains:

> Our company and other government linked firms are very strict with corporate governance activities. We have a lot to lose if we do not comply because of government intervention. Same goes with politically connected firms, the political people on board must show their capabilities, they really need to comply if not they will fail. If government firms keep on failing, it doesn't look good in their track record and later on it is difficult to ask assistance from the government.

Likewise, other respondent (EA3) stated that:

> Probably at the beginning the politically connected firms are having poor performance and the corporate governance is not strong. But now they are strict and moving towards corporate governance and need to keep up with the KPIs. But still certain companies which have less focus from the government are a bit weak. However, they are striving towards good corporate governance practices too.

According to another respondent (IA1):

> Politically connected firms having lower risk because being backed up by the government most of the time and their corporate governance have improved especially after 2005 due to the transformation program[18].

The government intervention is expected to produce better governance and improve the firm's business performance. In fact, through its representatives from the Ministry of Finance who sit on the board of directors, the government who owns shares in these firms can prevent any conflict of interest by the managers. The said representatives are responsible to control and monitor the management activities. Hence, it can be said that there is an increase in the accountability and efficiency of the Malaysian PCON firms through an effective ownership by the government. Interestingly, from the interviews conducted in this study, six (6) out of eight (8) respondents agreed that most of the PCON

[18] Transformation Program includes various strategies aimed at enhancing corporate developing social leaders and clarifying social leaders and upgrading the effectiveness of the Board.

firms have complied with the BMLR 2008 even before it became mandatory. As confirmed by one of the respondents (IA3):

> PCON firms are forming under Public Interest Entity (PIE), all requirements must be complied with and all documentation for audit must be updated. If any new regulation imposed by Bursa PCON firms will have to implement them. Some of the firms have complied with the regulations even before. It was voluntary during that time.

Likewise, another respondent (EA2) illustrates this point:

> The changes in regulations do not affect these firms that much because they are moving towards good governance. There are also firms complying with the good practices even before they became mandatory by Bursa.

The respondent (IA3) stresses that:

> The changes don't have any impact, they just want it to be clear and documented on the existence of requirements, but most of the firms already have that in place.

In summary, the launch of the Government Linked Firms (GLFs) Transformation Program by the Malaysian government to, among others, enhance the performance of GLFs in 2005 has improved the corporate governance practices and it was followed suit by politically connected firms.

It is to be noted that one of the objectives of the program is to upgrade the effectiveness of the board and reinforce the governance of the said firms. Further, the government expects its favoured firms to increase their investments and spending to make up for the shortfall arising from the government's move to cut its own expenditure and reduce the budget deficit (Najid and Abdul Rahman, 2011).

With the continuous improvement on corporate governance practices, the PCON firms are perceived to have better corporate governance and it is envisaged that these firms will reinforce this mindset of continuous improvement in their day-to-day operations. This is important because Malaysian PCON firms were once perceived to be associated with higher business risk and poor performance. Therefore, it is crucial that their performance which forms the backbone of the country's economy should improve and make a significant contribution to the nation's development and create value for other key stakeholders. As explained by one of the respondents (IA3) that:

> PCON firms are not 100% owned by government, we have shareholders and private owned which we are liable to them as well. We are answerable to these people. I don't agree that PCON firms carry higher risk and poor performance. We have a lot of things in place and complying with all these requirements.

6.5 Perceptions on the Regulatory Oversight and Audit Fees for HRFs

What then is the perception of the role of regulatory oversight vis-a-vis audit fees in Malaysia? From the interviews conducted in this present study, of the eight (8) respondents interviewed seven (7) of the respondents IA1, IA2, IA3, EA2, EA3, R1, and R2 opined that the role of regulators in Malaysia is very effective. The remaining respondent (EA1) viewed that the role of regulators in Malaysia as only effective. Further, all eight (8) respondents agreed that due to the role played by BNM, banking institutions and insurance firms are more governed as compared to firms in other industries. Since these highly regulated firms are subject to additional industry-specific oversight, they have to ensure that effective policies and practices are followed. Respondent (IA3) explained:

> Highly regulated firms are more governed because of Bank Negara, when there is a directive from Bank Negara, these firms have to comply…if not, their license will be revoked.

Further, as required by BNM, highly regulated firms have implemented most of the listing requirements even before it was mandated by Bursa Malaysia in 2008. As respondent (IA1) said:

> Highly regulated firms have implemented most of the listing requirements even before it was mandated by Bursa Malaysia…they have no choice but to comply especially if it is being enforced under Banking and Financial Institutions Act.

The enforcement of tighter regulations and greater emphasis for risk management and governance practices within the Malaysian financial institutions further indicate the growing importance of having strong audit committees and internal audit functions in fulfilling corporate governance responsibilities. Therefore, audit committee members are more likely to demand extensive audit to protect their reputation (Abbott and Parker, 2000; Carcello and Neal, 2000) and to avoid financial misstatement and non-compliance. It requires substantive audit testing and consequently higher audit fees. Seven (7) of the eight (8) respondents (IA1, IA2, EA1, EA2, EA3, R1 and R2) interviewed claimed that highly regulated firms pay higher audit fees as compared to less regulated firms. As noted by one of the respondents (EA3) that:

> Financial institutions are highly regulated and in terms of internal control, they are far better than the rest. When we audit banks, there will be a situation where we cannot find any misstatement or non-compliance because they have been audited several times in a year. Most of the times, we have nothing to report on but audit still needs to be done and audit fees need to be charged. Banks will always comply with the requirements even before they became mandatory by Bursa Malaysia.

Likewise, another respondent (EA1) also highlighted that highly regulated firms are also high risk firms and thus the auditors respond to the risk accordingly by subjecting them to appropriate audit testing. This is in line with Bedard *et al.* (2004). As respondent (EA1) said:

> Highly regulated firms are more governed. External auditor still needs to do proper audit because banks and insurance firms are considered as high risk firms. Because they are being monitored by an industry-specific regulator, we need to conduct a thorough audit testing. It doesn't mean that good governance and compliance will reduce the audit fee, but rather it depends on audit hours, audit work and the risk of signing the report.

In summary, the general perception of the respondents is that in Malaysia, regulatory oversight complements external audit monitoring. Thus, there should be an increase in the demand for extensive audit resulting in higher audit fees. The external auditors still need to carry out audit work even though they could, to some extent, rely on the audited clients' internal audit functions.

6.6 Summary of the Interview Findings

In summary, the interviews provide a more in-depth understanding of the relationship between the enhanced BMLR 2008 on audit committee characteristics and internal audit function attributes, and its implication on audit fees. The interviews are also focused on PCON firms and HRFs.

With reference to the findings of the interviews, the interviewees suggest that PCON firms and HRFs have been complying with the listing requirements specifically in relation to audit committee characteristics and internal audit function attributes. Audit committees have a duty not just overseeing the conduct of business in compliance with laws, they should also be effective stewards and guardians of the firm in respect of ethical values, and ensuring an effective governance structure for the appropriate management of risks and level of internal controls. Their involvement in strengthening internal controls is more likely to demand for higher audit quality in order to protect their reputation and at the same time does not compromise the quality of audit. The interviews also highlighted that PCON firms and HRFs engage in greater level of internal monitoring through the use of internal audit, which also demand higher quality external auditing. This is because they recognize the importance of both types of audit as mechanisms to strengthen corporate governance, thus they would complement each other's work. Due to this reason, audit committee members of PCON firms and HRFs would demand the external auditor to conduct substantive audit work and are willing to pay higher audit fees. It also indicates that regulatory oversight plays a vital role in enhancing good corporate governance practices and it complements the external audit as a monitoring mechanism.

The interviews also evidenced that the extent of external auditor reliance on internal audit function may not necessarily lead to a reduction in audit fees. It appears that the majority of the interviewees agreed that the external auditors to a certain extend are able to place some reliance on internal audit contribution. However, itt would not assist in reducing the external audit fees, hence, the PCON firms and high regulated firms pay higher audit fees.

6.7 Conclusion

This chapter provides a summary of interviews with eight (8) respondents who are regulators, heads of internal auditors and external auditors. This chapter gives an overview of the qualitative approach used in this research to support the quantitative results. The next chapter will discuss the results of the quantitative data analysis.

Chapter 7 PHASE 2: DATA ANALYSIS, FINDINGS AND DISCUSSION

7.1 Introduction

This chapter presents the data analysis for the study. While Chapters 4 and 5 explain the research design and method of analytical procedures, this chapter elaborates on each analysis for the two research models of Model 1 and Model 2, commencing with the descriptive statistics, Univariate analysis followed by the linear multivariate analysis. Statistical analyses for Model 1 and 2 are based on the t-tests and Chi-square analysis and both models used multiple regression statistical techniques. Detailed descriptions of the data screening and tests for assumptions of the regression analysis are provided. Subsequently, it will be followed with sensitivity analysis, conclusion and summary of findings at the end of the chapter.

7.2 Data Analysis

7.2.1 Data Screening and Cleaning

Prior to data analysis, the data used in this study is checked for errors. This is to ensure the accuracy of data entry and that there are no missing values when entering the data. Data screening and transformation techniques are also used to ensure that the data have been correctly entered and the distributions of variables are normal. Each continuous independent variable for Model 1 (Table 7.6) and Model 2 (Table 7.12) is tested for normality. This is because the parametric tests make assumptions about the shape of the population distribution, which is normally distributed. A normal curve is used to describe a symmetrical, bell shape curve, which has the greatest frequency of scores in the middle, with smaller frequencies towards the extremes (Gravetter and Wallnau, 2000). Normality can be assessed to some extent by obtaining skewness and kurtosis values. On a Univariate basis, the normality of the data can be assessed in four steps (Hair, Anderson, Tatham and Black, 1996). First, the skew value for each variable can be determined by calculating the Z value. Second, the kurtosis value is considered by using the critical non-normality value of greater than 10. Third, inspection is done for any deviations that exist in the frequency distributions. The fourth step involves the transformation of the data which can further reduce the normality assumptions by skewness and/or kurtosis. For each of the variable that violates the assumption of normality, a natural logarithmic transformation is applied.

Many of the statistical techniques are sensitive to outliers and at the initial data screening process, the researcher checks for extreme scores. The Univariate in the data set is identified through the use of box-plot, histogram, normal probability plots or detrended normal probability plots. According to Tabachnick and Fidell (1996), outliers are those with standardised residual values above 3.3 or less than -3.3. In this study, the above methods are used to examine the outliers. Once the outliers had been identified, the data are re-checked for its accuracy and the distribution of scores. A variable transformation which involves mathematically modifying the scores is feasible for Univariate outliers with extreme values. As suggested by Tabachnick and Fidell (2001), the first option for reducing the impact of Univariate outliers is through variable transformation. Multivariate outliers are checked by inspecting the Mahalanobis distances that are produced using SPSS regression program.

In this study, the value of skewness and kurtosis revealed that audit fees (AF), total assets (TA) and non-audit fees (NAF) have violated the assumption of normality. Further, the examinations of box-plot, histogram, normal probability plots or detrended normal probability plots and standardized residual values above 3.3 evidenced that extreme cases of outliers are found in these variables. Since those variables do not have normal distribution, they are transformed (Simunic, 1980; Francis and Simon, 1987; Craswell and Francis, 1999; Felix, Gramling and Maletta,, 2001) using natural log of the variables. Observations having a zero for log non-audit fees (LNAF) are re-coded to a small positive value (0.00001) to enable a logarithmic transformation.

7.2.2 Appropriateness of Regression Models

Multiple regressions make a number of assumptions about the data and it should not be violated. In this study, regression analysis is used for testing the hypotheses for Model 1 (H2a, 2b 2c, 3a and 3b) and Model 2 (H5a, 5b, 5c, 6a and 6b). Data set was analysed for its compatibility with the assumptions of multiple regression. More specifically, Tabachnick and Fidell (1996) suggested four major assumptions for multiple regression analysis which are:

(a) Sample Size

Different authors tend to give different guidelines concerning the number of cases required for multiple regressions. Tabachnick and Fidell (1996) give a formula for calculating sample size requirements taking into account the number of independent variables : $N > 50 + 8m$, where m = number of independent variables. For Model 1, the total number of the independent variables is 16 with 945 numbers of firm-year observations and there are 17 independent variables in Model 2 with 1045 numbers of firm-year observations. Hence, in both models, the sample size requirements are satisfied.

(b) Multicollinearity

Multicollinearity refers to high correlations among the independent variables and exists when the independent variables are highly correlated (r = 0.9 and above) (Pallant, 2001). In this study, the tolerance and VIF measures for each regression models were computed and analysed. If the value of tolerance is very low (near 0) and VIF > 10, this might indicate that multiple correlation with other variables is high, suggesting the possibility of multicollinearity. The result for Model 1 as shown in Table 7.6 [Model C, (I)] shows that the interaction term between audit committee independence and PCON (IND_PCON) VIF = 18.777. It indicates that the interaction term IND_PCON has violated the assumption of multicollinearity. However, Model 2 as shown in Table 7.12 [Model C (I), (II), (III), (IV) and (V)] indicates that tolerance of greater than 0.10 with the VIF of below 10, indicating that it does not appear to have violated this assumption.

(c) Outliers

Checking for extreme values is part of the initial data screening process. Outliers with extreme cases have considerable impact on the regression analysis and should be deleted or modified to reduce their influence. Univariate outliers are detected during data screening and multivariate outliers are detected using statistical methods such as Mahalanobis distance.

With reference to the Univariate outliers, no extreme outliers for the transformed variables were found for Model 1 and Model 2. However, for Model 1, an examination of the Mahalanobis distance values indicated that cases 78, 127 and 145 were multivariate outliers among the independent variables. The value for case 78 was 58.220, case 127 was 66.693

and case 145 was 71.161, were greater than the critical Chi-square of 40.790 at an alpha level of 0.001.[19] For Model 2, an examination of the Mahalanobis distance values indicated that cases 961 (82.033), 981 (72.695), 983 (86.520), 1001 (72.470) and 1023 (76.430) were multivariate outliers since the values were greater than the critical Chi-square of 40.790 at an alpha level of 0.001. For Model 1, regression analyses were undertaken with the multivariate outliers removed from the sample. Further analysis indicated that the exclusion of the multivariate outliers did not result in any significant differences in terms of the value of adjusted R^2 for Model 1. According to Pallant (2001), with large samples, it is common to find multivariate outliers, and if it is only a few, it may not be necessary to take any action. Thus, in this study the multivariate outliers were retained for Model 1. However, for Model 2 regression analyses were undertaken with the multivariate outliers removed from the sample. This is because the analysis indicated that the exclusion of the multivariate outliers resulted in significant differences in terms of the value of adjusted R^2 for Model 2. Hence, in this study, the multivariate outliers were removed for Model 2.

(d) Normality, linearity, homoscedasticity and independence of residuals

An examination of residuals scatter plots and the Normal Probability Plot are used to test the above assumptions. It is assumed that the differences between the obtained and predicted dependent variable scores are normally distributed. Further, it is also assumed that the residuals have a linear relationship with the predicted dependent variable scores, and that the variance of the residuals is the same for all predicted scores. In this study, Model 1 and Model 2 indicated that there is no clear relationship between residuals and predicted values, thus the assumption of linearity is not violated. The normal probability

[19] An alpha of 0.001 is recommended by Coakes and Steed (2003)

plot of the regression standardised residuals for the dependent variable and histogram also indicated a relatively normal distribution, suggesting no major deviations from normality.

7.3 Model 1: Politically Connected (PCON) Firms and non-Politically Connected (non-PCON) Firms

7.3.1 Descriptive Analysis

The sample data comprises of 945 firm-year observations for 2005 to 2009. Descriptive analysis is used to describe the characteristics of the sample and the control sample. Table 7.1 below provides descriptive statistics for the continuous and indicator variables which contain summary statistics for the pre-test period and post-test period. Since the descriptive statistics are for continuous and dichotomous variables, both t-tests and Chi-square tests are used where appropriate to test for the differences. The descriptive analysis shows that the average audit fees (AF) increased from RM311,428 during the pre-test period to RM392,038 during post-test period. On average, audit committee independence (IND) increased from 81.9 percent in pre-test period to 97.1 percent for post-test period. Additionally, the sample firms have audit committee members that are predominantly diligent (DIL) (5.04 and 5.18) having financial or accounting expertise (EXP) (1.37 and 1.42). The objectivity (OBJ) increased from 72 percent to 95 percent, on which it shows an increase on the internal audit function direct reporting to the audit committee. Finally, the mean on the work performance (WP) on activities performed and disclosed during the year by the internal audit function increased from 10.05 to 11.76, respectively.

Table 7.1: Panel A - Descriptive statistics for the number of observations (n= 945)

	Pre-test period (Year 2005 to 2007)			*Post-test period (Year 2008 to 2009)*			
Variable	*Mean*	*Std. Dev*	*Median*	*Mean*	*Std. Dev*	*Median*	*t-tests/Chi-square*
LAF	11.885	0.968	11.751	12.094	0.993	11.9530	-3.188*
AF	311428.010	806839.072	127000.000	392038.280	1089342.132	157350.00	-1.305*
LTA	13.2863	1.483	13.099	13.424	1.485	13.120	-1.394
TA	2578740.300	8119084.347	489796.000	2973801.510	7970066.839	505049.000	-0.738
LNAFº	3.264	10.599	9.305	4.327	10.13587	9.648	-1.551
NAF	178291.090	789427.163	11000.000	193984.700	15500.000	822656.012	-0.294
SUB	20.720	12.000	31.270	22.740	33.511	13.000	-0.945
FOREIGN	2.080	8.920	0.000	2.380	9.486	0.000	-0.485
SEG	3.090	1.594	3.000	3.090	1.594	3.000	-0.025
ZFC	-2.957	1.020	-3.076	-2.947	1.037	-3.041	-0.138
ROA	0.066	0.085	0.061	0.060	0.090	0.0622	0.966
LEV	0.269	0.164	0.248	0.268	0.164	0.245	0.093
LOSS	0.180	*	0.000	0.190	*	0.000	©0.733
AQ	0.690	*	1.000	0.680	*	1.000	©0.774
PCON	0.350	*	0.000	0.350	*	0.000	©0.528
INST&MGRL	0.290	*	0.000	0.290	*	0.000	©0.505
FAMILY	0.370	*	0.000	0.370	*	0.000	©0.397
IND	0.819	0.167	0.750	0.971	0.091	1.000	-17.928*
DIL	5.040	1.559	5.000	5.180	1.677	5.000	-1.297
EXP	1.370	0.613	1.000	1.420	0.626	1.000	-1.053
OBJ	0.720	*	1.000	0.950	*	1.000	©0.000*
WP	10.050	2.789	10.000	11.760	2.340	12.000	-10.191*

$p < 0.05$; © Chi-square tests for dichotomous variables; t-tests for other variables ºObservations having a zero for LNAF are re-coded to a small positive value (0.00001) to enable a logarithmic transformation. *not necessary

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non-audit fees (in RM) while LNAF is natural logarithm of non-audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; SEG is the number of business segments; ZFC is the Zmijewski score for financial crisis; ROA is net profit before tax over total assets; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to '1' if the firm has made loss in any of the years, '0' if otherwise; AQ an indicator variable equals to '1' if the firm hires Big4 auditor and '0' if otherwise; INST&MGRL is an indicator variable '1', with reference to PCON and '0' otherwise; FAMILY is an indicator variable '1', with reference to PCON and '0' otherwise; IND is the proportion of independent non-executive directors to audit committee; DIL is the number of meetings; EXP is the number of audit committee with accounting or finance qualification; OBJ is an indicator variable, '1' if the internal audit function reports to audit committee, and '0' if otherwise; WP is the voluntary disclosure on IAF under Para 43 of SIC.

For the control variables, the mean of total assets (TA) of the firms for pre and post-test periods are RM2,578,740 and RM2,973,801, respectively. The mean for the variable indicating non-audit fees (NAF) is RM178,291 (pre-test period) and RM193,984 (post-test period) while the mean ratio of total liabilities over total assets (LEV) is 0.269 and 0.268 for pre and post-test period respectively. The mean for Zmijewski score (ZFC), indicating financial condition index is -2.957 (pre-test period) and -2.947 (post-test period) respectively and the average of ROA for both periods is 0.06. The average number of local subsidiaries (SUB) is 20.72 (pre-test period) and 22.74 (post-test period), and the mean for foreign subsidiaries (FOREIGN) is 2.08 and 2.38 for pre-test and post-test periods. (Descriptive statistics results for years 2005 to 2009 are attached in Appendix D).

Panel B of Table 7.1 reports the frequency of ownership structure for the sample firms. Thirty-six percent of the samples are politically connected (PCON) firms, 34% belongs to family-owned firms (FAMILY), followed by the institutional and managerial owned firms (INSTL&MGRL) of 30%.

Table 7.1: Panel B - Frequency of Ownership Structure

		Frequency		Percentage
Politically Connected Firms		68		36%
Non-Politically Connected Firms:		171		64%
Family Ownership Firms	65		34%	
Institutional Ownership Firms& Managerial Ownership Firms	56		30%	
		189		**100%**

7.3.2 Univariate Analysis

The analysis includes the Univariate test, t-tests analysis and Pearson's correlation tests between the dependent variable (audit fees) and independent variables of audit committee characteristics and internal audit function attributes.

Table 7.2 shows Univariate analysis for the continuous and indicator variables in Panels A and B respectively. Panel A represents pre-test period and Panel B represents post-test period sample for PCON, FAMILY and INST&MGRL firms, with the descriptive of mean, standard deviation and median. The descriptive statistics show that for samples in both periods, PCON firms are bigger in terms of total assets and have a larger number of local subsidiaries (SUB) and foreign subsidiaries (FOREIGN). The PCON firms also have higher non-audit fees (NAF), a higher audit quality (AQ) and a lower financial crisis index (ZFC).

In general, PCON firms have higher average audit fees than non-PCON firms in both periods. The descriptive statistics also show that the average audit fees for PCON firms increased from RM598,771 during the pre-test period to RM739,045 during post-test period. However, the average audit fees for FAMILY and INST&MGRL firms experienced a small increase for the respective periods (i.e., RM148,641 and RM159,899 for the pre-test period, RM189,890 and RM216,048 for the post-test period).

Table 7.2: Univariate Analysis for sample firms (n = 945)
Panel A: Pre-test period (Year 2005 to 2007)

	PCON Firms (n=340)			*Non-PCON Firms*					
				FAMILY (n=325)			*INST&MGRL (n=280)*		
Variable	*Mean*	*Std. Dev*	*Median*	*Mean*	*Std. Dev*	*Median*	*Mean*	*Std. Dev*	*Median*
LAF	12.408	1.084	12.370	11.540	0.767	11.494	11.684	0.758	11.648
AF	598771.870	1278824.347	241000.000	148641.270	247116.808	96125.000	159899.500	142376.015	114500.000
LTA	14.263	1.502	14.115	12.631	1.071	12.575	12.925	1.283	12.799
TA	5733265.990	12757264.082	1362503.000	597571.000	985081.186	289265.000	696097.310	2987325.527	362192.000
LNAFº	7.068	9.309	10.905	1.603	10.494	8.699	0.577	10.916	8.047
NAF	365415.530	831497.136	54500.000	23350.490	41619.141	6000.000	55842.250	155820.726	3127.000
SUB	32.580	46.663	19.000	14.480	15.819	9.000	13.850	12.031	10.000
FOREIGN	5.120	14.405	0.000	0.270	0.850	0.000	0.590	1.757	0.000
SEG	3.400	1.724	3.000	2.720	1.330	3.000	3.170	1.647	3.000
ZFC	-2.923	0. 842	-3.017	-3.212	0.842	-3.256	-3.002	0.889	-3.001
ROA	0.061	0.065	0.063	0.061	0.053	0.061	0.055	0.062	0.060
LEV	0.292	0.160	0.256	0.225	0.128	0.220	0.296	0.197	0.286
LOSS	0.200	*	1.000	0.140	*	0.000	0.210	*	0.000
AQ	0.790	*	1.000	0.620	*	1.000	0.660	*	1.000
IND	0.883	0.157	1.000	0.796	0.144	0.750	0.769	0.182	0.750
DIL	5.470	2.143	5.000	4.790	1.099	5.000	4.830	0.982	5.000
EXP	1.370	0.628	1.000	1.350	0.613	1.000	1.410	0.596	1.000
OBJ	0.740	*	1.000	0.750	*	1.000	0.670	*	1.000
WP	10.000	3.050	11.000	9.970	2.644	10.000	10.220	2.632	10.000

p < 0.05; © Chi-square tests *not necessary

ºObservations having a zero for LNAF are re-coded to a small positive value (0.00001) to enable a logarithmic transformation.

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non-audit fees (in RM) while LNAF is natural logarithm of non-audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; SEG is the number of business segments; ZFC is the Zmijewski score for financial crisis; ROA is net profit before tax over total assets; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to '1' if the firm has made loss in any of the years, '0' if otherwise; AQ an indicator variable equals to '1' if the firm hires Big4 auditor and '0' if otherwise; IND is the proportion of independent non-executive directors to audit committee; DIL is the number of meetings; EXP is the number of audit committee with accounting or finance qualification; OBJ is an indicator variable, '1' if the internal audit function reports to audit committee, and '0' if otherwise; WP is the voluntary disclosure on IAF under Para 43 of SIC.

Panel B: Post-test period (Year 2007 to 2008)

	PCON Firms (n=340)			*Non-PCON Firms*					
				FAMILY (n=325)			*INST&MGRL (n=280)*		
Variable	*Mean*	*Std. Dev*	*Median*	*Mean*	*Std. Dev*	*Median*	*Mean*	*Std. Dev*	*Median*
LAF	12.631	1.066	12.582	11.719	0.808	11.700	11.916	0.825	11.774
AF	739045.690	1727857.350	301500.000	189890.490	371583.932	120300.00	216048.510	248825.789	130000.000
LTA	14.313	1.510	14.058	12.775	1.064	12.673	13.105	1.315	12.948
TA	5945714.890	11669897.660	1468634.500	690219.490	1235117.632	318293.500	1839621.100	5107855.012	434299.000
LNAFº	8.248	8.009	10.819	2.131	10.495	110.158	2.228	10.649	9.023
NAF	461066.970	1324152.273	50000.000	33455.290	69257.859	5500.000	64752.970	245056.721	8300.000
SUB	34.630	49.865	19.000	15.590	15.611	10.000	16.970	16.815	12.000
FOREIGN	5.630	15.282	1.000	0.400	0.953	0.000	0.820	2.212	0.000
SEG	3.400	1.726	3.000	2.730	1.330	3.000	3.170	1.649	3.000
ZFC	-2.989	0.857	-2.957	-3.267	0.849	-3.281	-2.911	0.890	-2.942
ROA	0.057	0.067	0.060	0.060	0.059	0.060	0.045	0.069	0.050
LEV	0.283	0.168	0.254	0.217	0.123	0.213	0.312	0.188	0.275
LOSS	0.210	*	0.000	0.150	*	0.000	0.220	*	0.000
AQ	0.790	*	1.000	0.630	*	1.000	0.620	*	1.000
IND	0.969	0.087	1.000	0.981	0.712	1.000	0.960	0.115	1.000
DIL	5.630	2.332	5.000	4.800	0.876	5.000	5.110	1.321	5.000
EXP	1.470	0.668	1.000	1.350	0.639	1.000	1.430	0.550	1.000
OBJ	0.980	*	1.000	0.970	*	1.000	0.880	*	1.000
WP	11.940	2.368	12.000	11.53	2.500	12.000	11.820	2.082	12.000

p < 0.05; © Chi-square tests *not necessary

ºObservations having a zero for LNAF are re-coded to a small positive value (0.00001) to enable a logarithmic transformation.

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non-audit fees (in RM) while LNAF is natural logarithm of non-audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; SEG is the number of business segments; ZFC is the Zmijewski score for financial crisis; ROA is net profit before tax over total assets; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to '1' if the firm has made loss in any of the years, '0' if otherwise; AQ an indicator variable equals to '1' if the firm hires Big4 auditor and '0' if otherwise; IND is the proportion of independent non-executive directors to audit committee; DIL is the number of meetings; EXP is the number of audit committee with accounting or finance qualification; OBJ is an indicator variable, '1' if the internal audit function reports to audit committee, and '0' if otherwise; WP is the voluntary disclosure on IAF under Para 43 of SIC.

As expected, the sample firms' audit committee characteristics and internal audit functions attributes record significantly higher scores for the post-test period. Corporate governance generally improves after 2008 especially for PCON firms in comparison with FAMILY and INST&MGRL firms in terms of DIL, EXP, OBJ and WP. It shows that the PCON firms are complying with the newly amended BMLR 2008 on audit committee characteristics and internal audit function attributes. This is consistent with past studies (Abdul Wahab *et al.,* 2011; Chan *et al.,* 1993; Collier and Gregory, 1996; O'Sullivan, 1999 and 2000; Carcello *et al.,* 2002) that document higher audit fees for firms with improved governance, which is in line with the demand side explanation. It was further supported by the interviews conducted in the present study where the respondents IA1, IA3, EA2, and EA3 (see Chapter 6, Section 6.4) perceive that PCON firms are now more conscious and moving towards good governance practices.

7.3.3 Correlation

Table 7.3 reports the correlations between the variables used in the regressions for pre-test and post-test periods for Model 1. Test of correlation is used to test the degree of relationships between the variables under study. The objective is to determine if there is any multicollinearity problem among the variables. Multicollinearity problem exists if the independent variables are highly correlated at each other with correlation values exceeding 0.9 (Pallant, 2001).

Table 7.3 shows the correlation matrix between audit fees and other variables. From the table, audit committee independence and diligence have a positive and significant association with audit fees for pre-test period (post-test period: diligence and expertise), suggesting that audit committee's independence, diligence and with expertise demand for higher quality audit from external auditors, hence higher audit fees. Further, internal audit function attributes, namely objectivity and work performance are positively significant with audit fees for both testing periods, suggesting as internal audit function increases, the audit fees increase too.

This association helps to answer the second research question on the internal governance mechanisms of audit committee characteristics and internal audit function attributes, and audit fees. The signs for the control variables are all in the right direction and significant in the testing periods except for the coefficient for LOSS, ROA and LEV. Significant results in the predicted direction are obtained for the coefficients for TA, NAF, SUB, FOREIGN, SEG, AQ and FAMILY. While a few governance variables are significantly correlated with each other, their correlations do not indicate that multicollinearity is a serious problem.

7.3.4 T-tests and Chi-square Analysis for PCON Firms

Table 7.4 shows t-tests and Chi-square analysis for PCON firms and non-PCON firms. The analytical procedure is applied to answer the first research question as to whether PCON firms pay higher audit fees than non-PCON firms and to test the following hypothesis:

H1: ***PCON firms pay higher audit fees than non-PCON firms.***

Table 7.3: Pearson Correlation Matrix for sample firms (Year 2005 – 2009, n = 945)

	LAF	*AF*	*LTA*	*TA*	*LNAF*	*NAF*	*SUB*	*FOREIGN*	*SEG*	*ZFC*	*ROA*	*LEV*	*LOSS*	*AQ*	*INST& MGRL*	*FAMILY*	*IND*	*DIL*	*EXP*	*OBJ*	*WP*
Panel A: Pre-test period (2005 to 2007)																					
LAF	1	0.809**	0.769**	0.446**	0.315**	0.434**	0.744**	0.469**	0.386**	0.204**	0.107*	0.183**	-0.124**	0.262**	-0.139**	-0.253**	0.089*	0.254**	0.058	0.120**	0.197**
AF		1	0.642**	0.421**	0.185**	0.649**	0.888**	0.875**	0.275**	0.037	0.138**	0.040	-0.074	0.115**	-0.120**	-0.137**	0.076	0.092*	0.098*	-0.051	0.001
LTA			1	0.626**	0.286**	0.440**	0.546**	0.400**	0.270**	0.198**	0.093*	0.190**	-0.134**	0.312**	-0.162**	-0.312**	0.173**	0.283**	0.057	0.081	0.109**
TA				1	0.159**	0.526**	0.378**	0.344**	0.161**	0.134**	0.053	0.129**	-0.095*	0.124**	-0.113**	-0.168**	0.135**	0.318**	0.047	0.035	0.124**
LNAF					1	0.292**	0.203**	0.151**	0.070	0.047	0.124**	0.086*	-0.066	0.211**	-0.163**	-0.099*	0.125**	0.127**	0.038	0.057	0.108*
NAF						1	0.539**	0.596**	0.138**	0.044	0.114**	0.065	-0.033	0.147**	-0.119**	-0.167**	0.078	0.287**	0.110**	0.043	0.099*
SUB							1	0.819**	0.399**	0.088*	0.100*	0.089*	-0.066	0.116**	-0.139**	-0.142**	0.093*	0.101*	0.103*	-0.067	0.006
FOREIGN								1	0.212**	0.003	0.154**	0.020	-0.061	0.104*	-0.106*	-0.126**	0.079	0.000	0.062	-0.071	-0.012
SEG									1	0.031	-0.046	0.049	-0.038	0.016	0.028	-0.176**	-0.020	0.036	0.101*	-0.037	0.015
ZFC										1	-0.294**	0.808**	0.235**	0.061	0.031	-0.150**	-0.088*	0.099*	-0.008	0.054	0.079
ROA											1	-0.065	-0.616**	0.043	-0.042	0.040	0.099*	-0.036	0.006	0.025	0.032
LEV												1	0.107*	0.034	0.102*	-0.211**	-0.088*	0.124**	-0.067	0.034	0.065
LOSS													1	-0.053	0.048	-0.077	-0.024	0.001	0.042	0.036	0.026
AQ														1	-0.047	-0.099*	0.032	0.073	-0.002	-0.070	0.010
INST_MGRL															1	-0.475**	-0.182**	-0.086*	0.039	-0.074	0.034
FAMILY																1	-0.087*	-0.115**	-0.031	0.050	-0.017
IND																	1	0.125**	0.059	0.140**	0.048
DIL																		1	0.086*	0.063	0.081
EXP																			1	-0.068	0.044
OBJ																				1	0.462**
WP																					1

Table 7.3 – continued

	LAF	*AF*	*LTA*	*TA*	*LNAF*	*NAF*	*SUB*	*FOREIGN*	*SEG*	*ZFC*	*ROA*	*LEV*	*LOSS*	*AQ*	*INST& MGRL*	*FAMILY*	*IND*	*DIL*	*EXP*	*OBJ*	*WP*
Panel B: Post-test period (2008 to 2009)																					
LAF	1	.805**	0.782**	0.504**	0.318**	0.349**	0.745**	0.481**	0.385**	0.255**	0.152**	0.252**	-0.052	0.272**	-0.114*	-0.285**	0.007	0.252**	0.161**	0.145**	0.170**
AF		1	0.630**	0.611**	0.165**	0.616**	0.814**	0.796**	0.264**	-0.016	0.105*	-0.003	-0.050	0.110*	-0.102*	-0.139**	0.047	0.112*	0.185**	0.061	-0.016
LTA			1	0.638**	0.275**	0.384**	0.569**	0.364**	0.240**	0.117*	0.179**	0.220**	-0.103*	0.324**	-0.131*	-0.325**	-0.003	0.264**	0.142**	0.068	0.095
TA				1	0.132*	0.436**	0.484**	0.400**	0.130*	0.137**	0.065	0.196**	-0.099	0.139**	-0.084	-0.210**	0.042	0.343**	0.144**	0.064	0.130*
LNAF					1	0.234**	0.204**	0.172**	0.115*	0.085	0.071	0.093	0.003	0.255**	-0.118*	-0.175**	0.056	0.188**	0.145**	0.116*	-0.005
NAF						1	0.600**	0.742**	0.218**	0.022	0.112*	0.009	-0.022	0.146**	-0.099	-0.147**	0.051	0.160**	0.221**	0.049	0.016
SUB							1	0.808**	0.382**	0.030	0.127*	0.018	-0.063	0.126*	-0.109*	-0.160**	0.031	0.093	0.199**	0.073	-0.035
FOREIGN								1	0.195**	-0.067	0.113*	-0.064	-0.036	0.112*	-0.102*	-0.158**	0.060	0.039	0.192**	0.044	-0.035
SEG									1	0.066	-0.012	0.053	-0.032	-0.014	0.029	-0.172**	-0.061	0.047	0.137**	0.014	0.017
ZFC										1	-0.283**	0.779**	0.280**	-0.002	0.115*	-0.174**	-0.035	0.119*	-0.047	0.045	0.072
RISK											1	-0.106*	-0.596**	0.129*	-0.107*	0.074	-0.076	-0.056	0.096	-0.011	-0.081
LEV												1	0.160**	0.030	0.174**	-0.233**	-0.054	0.143**	-0.068	-0.002	0.111*
LOSS													1	-0.103*	0.051	-0.083	0.092	0.060	-0.107*	0.054	0.001
AQ														1	-0.072	-0.105*	0.043	0.078	0.017	-0.009	0.017
INST_MGRL															1	-0.474**	-0.071	-0.030	0.011	-0.191**	0.018
FAMILY																1	0.081	-0.167**	-0.075	0.079	-0.074
IND																	1	0.034	-0.030	0.096	0.016
DIL																		1	0.223**	-0.010	0.110*
EXP																			1	0.006	0.058
OBJ																				1	0.365**
WP																					1

Significant at *10, **5 and ***1 per cent levels.

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non-audit fees (in RM) while LNAF is natural logarithm of non-audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; SEG is the number of business segments; ZFC is the Zmijewski score for financial crisis; ROA is net profit before tax over total assets; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to '1' if the firm has made loss in any of the years, '0' if otherwise; AQ an indicator variable equals to '1' if the firm hires Big4 auditor and '0' if otherwise; IND is the proportion of independent non-executive directors to audit committee; DIL is the number of meetings; EXP is the number of audit committee with accounting or finance qualification; OBJ is an indicator variable, '1' if the internal audit function reports to audit committee, and '0' if otherwise; WP is the voluntary disclosure on IAF under Para 43 of SIC.

The results generally show significant differences for the groups except for ZFC, ROA, LEV, LOSS, audit committee EXP, internal audit OBJ and WP. There was a statistically significant difference at the $p<0.05$ level in AF scores for the groups (t=11.914). The t-tests indicates that the mean score for AF for PCON firms (μ=RM654,881.400, SD=RM1,474,057.761) is significantly different from non-PCON firms (μ=RM172,762.100 SD=RM260,455.637). From the table, it shows that PCON firms pay higher audit fees in comparison with non-PCON firms, thus fully support Hypothesis 1. This indicates that PCON firms demand for substantive audit testing and improve audit quality from external auditors and willing to pay higher audit fees.

The audit committee IND is significant at t=5.418 for the groups. The PCON firms have higher IND mean score of 91.7 percent compared to non-PCON firms of 85.9 percent. It indicates that the PCON firms have higher percentage of audit committee members who are independent non-executive directors. Similarly, audit committee DIL is also significant at t=6.285 for both groups. It indicates that the mean score for PCON firms (μ=5.530 SD=2.218) is significantly different from non-PCON firms (μ=4.860 SD=1.071). It can be further concluded that the audit committee members in PCON firms conduct an average of 5.5 meetings in a year.

Similarly, given the t-value of 15.151 with a significant level of $p<0.05$, the NAF is statistically significant for both groups. The mean score for PCON firms (μ= RM403790.660 SD= RM1056255.037) is significantly different from non-PCON firms (μ= RM41562.600 SD= RM137426.720). The client size measured by total assets (TA) is statistically significant for both groups, with PCON firms having larger total assets (t=5817479.970 SD=12320223.663).

Table 7.4: T-tests and Chi-square results for PCON firms for sample firms (2005 to 2009)

Variable	PCON Firms (*n* = 340) Mean	Std. Dev	non-PCON Firms (*n* = 605) Mean	Std. Dev	t-value/ Chi-square
LAF	12.497	1.081	11.686	0.793	11.914*
AF	654881.400	1474057.761	172762.100	260455.637	5.936*
LTA	14.283	1.503	12.824	1.183	15.151*
TA	5817479.970	12320223.660	987390.520	2795028.070	7.056*
LNAFº	7.541	8.817	1.559	10.628	9.253*
NAF	403790.660	1056255.037	41562.600	137426.720	6.239*
SUB	33.400	47.906	15.000	15.053	6.846*
FOREIGN	5.330	14.742	0.480	1.469	5.997*
SEG	3.400	1.742	2.920	1.498	4.323*
ZFC	-2.949	0.848	-3.115	0.874	2.818
ROA	0.059	0.065	0.059	0.059	0.704
LEV	0.288	0.164	0.257	0.164	2.782
LOSS	0.200	*	0.180	*	©0.295
AQ	0.790	*	0.630	*	©0.000*
IND	0.917	0.139	0.859	0.166	5.418*
DIL	5.530	2.218	4.860	1.071	6.285*
EXP	1.410	0.645	1.380	0.603	0.720
OBJ	0.830	*	0.800	*	©0.258
WP	10.770	2.952	10.710	2.632	0.327

*p < 0.05; © Chi-square tests for dichotomous; t-tests for other variables; *not necessary ºObservations having a zero for LNAF are re-corded to a small positive value (0.00001) to enable a logarithmic transformation.

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in M$) while LTA is natural logarithm of total assets; NAF is non audit fees (in M$) while LNAF is natural logarithm of non audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; SEG is the number of business segments; ZFC is the Zmijewski score for financial crisis; ROA is net profit before tax over total assets; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to 1 if the company has made loss in any of the years, 0 otherwise; AQ an indicator variable equals to 1 if the company hire Big4 auditor and 0 otherwise; PCON an indicator variable, 1 for politically connected firms, and 0 otherwise; IND is the proportion of non executive directors to audit committee; DIL is the number of meetings; EXP is the number of AC with accounting or finance qualification; OBJ is an indicator variable, 1 if the internal audit function reports to audit committee, and 0 otherwise; WP is the voluntary disclosure on IAF under Para 43 of SIC.

Additionally, comparable evidence of significance was also noted for the measure of audit complexity namely, local subsidiaries (SUB), foreign subsidiaries (FOREIGN) and business segments (SEG) at $p<0.05$ level of significance for the groups.

7.3.5 Multivariate Analysis

A multiple regression was performed between audit fees (AF) as the dependent variable and audit committee characteristics (IND, DIL, and EXP) and internal audit functions attributes (OBJ and WP) as the experimental variable. Analysis was performed using SPSS REGRESSION for evaluation of assumptions. Model 1 is as shown below:

$$LAF = \beta_0 + \beta_1 TA + \beta_2 NAF + \beta_3 SUB + \beta_4 FOREIGN + \beta_5 SEG + ß_6 ROA + ß_7 LEV + \beta_8 AQ + \beta_9 LOSS + \beta_{10} PRD + \beta_{11} PCON + \beta_{12} IND + \beta_{13} DIL + \beta_{14} EXP + \beta_{15} OBJ + \beta_{16} WP + \beta_{17} \mathbf{IND\_PCON} + \beta_{18} \mathbf{DIL\_PCON} + \boldsymbol{\beta_{19}} \mathbf{EXP\_PCON} + \boldsymbol{\beta_{20}} \mathbf{OBJ\_PCON} + \mathbf{WP\_PCON} + \varepsilon,$$

Where:

LAF	=	Audit fees paid by the client (natural logarithm of AF)
Variables		
TA	=	Natural logarithm of total assets.
NAF	=	Natural logarithm of non audit fees.
SUB	=	Number of client local subsidiaries.
FOREIGN	=	Number of client foreign subsidiaries.
SEG	=	Number of business segments.
ROA	=	Profit before tax over total assets.
LEV	=	Proportion of total liability over total assets.
AQ	=	An indicator variable equals to ‘1’ if Big4 auditor, and ‘0’ if otherwise.
LOSS	=	An indicator variable equals to ‘1’ if the firm has made loss in any of the years and ‘0’ if otherwise.
PRD	=	An indicator variable equals to ‘1’ for post-test period and 0 if otherwise.
PCON	=	An indicator variable equals to ‘1’ for PCON firms and ‘0’ if otherwise.
Experimental Variables		
IND	=	Proportion of independent non-executive directors to AC.
DIL	=	Number of AC meetings.
EXP	=	Number of AC with accounting or finance qualification.

OBJ	=	An indicator variable equals to ‘1’ if the IA reports to AC and ‘0’ if otherwise
WP	=	Number of voluntary disclosure under IAF as per Para 43 of Statement of Internal Control (SIC)
IND_PCON	=	Interaction between IND and PCON
DIL_ PCON	=	Interaction between DIL and PCON
EXP_ PCON	=	Interaction between EXP and PCON
OBJ_ PCON	=	Interaction between OBJ and PCON
WP_ PCON	=	Interaction between WP and PCON
ε	=	Error term

Table 7.5 describes the variables and the expected direction of their relationship with the internal governance mechanisms of audit committee characteristics and internal audit functions attributes.

Table 7.5: Variables Description and Expected Direction for Model 1

Variable(s)	Description and Measurement	Exp Sign	Hypo
Dependent Variable			
AF	Audit fees paid by the client (Natural logarithm of audit fees used in regression model).		
Experimental Variables			
AC Characteristics			
IND	The proportion of independent non-executive directors to audit committee.	+	
DIL	Number of audit committee meetings	+	
EXP	Number of audit committee members with accounting or finance qualification	+	
OBJ	An indicator variable equals to ‘1’ if the internal audit function reports directly to audit committee and ‘0’ otherwise.	+	
WP	Voluntary disclosure under IAF as per Para 43 of Statement of Internal Control (SIC)	+	
Control Variables			
TA	Total assets of client at the end of fiscal year (Natural logarithm of total assets).	+	
NAF	Total non-audit fees paid by client (Natural logarithm of NAF).	+	
SUB	Number of client’s local subsidiaries.	+	
FOREIGN	Number of client’s foreign subsidiaries.	+	
SEG	Number of business segments.	+	
ROA	Profit before tax over total assets.	-	
LEV	Total liability over total assets	-	
AQ	An indicator variable equals to ‘1’ if the firm hire Big4 auditor and ‘0’ if otherwise.	+	
LOSS	An indicator variable equals to ‘1’ if the firm has made loss in any of the periods and ‘0’ if otherwise.	+	
PRD	An indicator variable equals to ‘1’ for post-test period and ‘0’ if otherwise.	+	

PCON	An indicator variable, ‘1’ for PCON firms and ‘0’ if otherwise.	+	
IND_PCON	Interaction between IND and PCON	+	2a
DIL_PCON	Interaction between DIL and PCON	+	2b
EXP_PCON	Interaction between EXP and PCON	+	2c
OBJ_PCON	Interaction between OBJ and PCON	+	3a
WP_PCON	Interaction between WP and PCON	+	3b

Table 7.6 tabulates the results of the analysis for the 189 non-financial sample firms from 2005 to 2009 and it presents the linear regression results for testing the hypotheses. The analytical procedure is applied to answer the second research question on the moderating effect of political connections on the association between audit committee characteristics and internal audit function attributes, and audit fees for PCON firms and to test the following hypotheses:

H2a: The association between AC independence and audit fees is stronger post-BMLR 2008 implementation for PCON than non-PCON firms.

H2b: The association between AC diligence and audit fees is stronger post-BMLR 2008 implementation for PCON than non-PCON firms.

H2c: The association between AC expertise and audit fees is stronger post-BMLR 2008 implementation for PCON than non-PCON firms.

H3a: The association between internal audit function attribute, namely objectivity and audit fees is stronger post-BMLR 2008 implementation for PCON than non-PCON firms.

H3b: The association between internal audit function attribute, namely work performance and audit fees is stronger post-BMLR 2008 implementation for PCON than non-PCON firms.

Table 7.6 presents the multiple regression results for testing the hypotheses. In testing the validity of the models used in the study, the traditional audit fee model introduced by Simunic (1980) is employed whereby the natural log of audit fees is regressed on control (Simunic, 1980; Yatim *et al.*, 2006; Gul, 2006; Ferguson, 2005) and experimental variables. Results in Models A, B and C are significant at one percent significant level (p=0.000), with an adjusted R^2 of at least 79.2 percent which is comparable with other Malaysian studies in this area (Yatim *et al.,* 2006; Abdul Wahab *et al.,* 2011).

Model A shows the association between external audit fees on 11 control variables derived from extant literature (Abbott *et al.,* 2003, Goodwin and Kent, 2006; Yatim *et al.,* 2006; Abdul Wahab *et al.,* 2009). The client size (TA) coefficient (0.032, t=1.506) is positive and significant at one percent significant level indicating that the larger the size of firms, the higher the audit fees charged. The coefficient (0.050, t=2.245) on NAF is also positive and significant at one percent significant level. Besides that, SUB coefficient is found to be positive and significant at one percent significant level (0.688, t=21.745) and has the largest beta coefficient indicating that SUB makes the strongest unique contribution to explain the dependent variable, when the variance explained by all other variables in the model is controlled for. FOREIGN and SEG indicate a positive and significant relationship with the coefficients of 0.257 and 0.226 respectively. It indicates that as the complexity becomes higher, the audit fees also increase. Audit quality (AQ) and period (PRD) are also positive and significant at p<0.01. Further, the PCON variable coefficient is positive and significant at t=0.040. However, LEV is negatively associated with audit fees at (t=-4.412), indicating that audit fees are higher if external auditors are expose to higher risk.

Model B introduces the audit committee characteristics IND, DIL and EXP, and internal audit function attributes OBJ and WP. The results show that external audit fees are positively and significantly associated with the audit committee independence (IND) and diligence (DIL) at p<0.01. Similarly, internal audit function attributes namely objectivity (OBJ) and work performance (WP) are also positively and significantly associated with audit fees at one percent significant level ($p<0.01$).

Prior research recommends that stronger audit committees demand for higher quality audits (Goodwin and Kent, 2006) and firms with strong governance practices engage in greater level of internal auditing and are connected with higher audit fees. Carcello *et al.* (2002) argue that high quality board demands for more external monitoring from external auditors. Further, as noted by the interviewees (IA1 and IA3) in the current study (see Chapter 6, Section 6.3), the audit committee members are very much involved in internal audit activities due to the additional roles mandated by the listing requirements in 2008. Thus, audit committee members who are independent, diligent and have financial expertise coupled with stronger internal audit function in PCON firms, demand for additional audit procedures from the external auditors especially for areas that subsequently reveal greater amounts of contention or risk, consequently higher audit fees.

The signs for the control variables are all in predicted directions. Following prior research (Simunic, 1980; Francis and Simon, 1987; Craswell *et al.*, 1995), audit fees (AF) is positively associated with TA, NAF, SUB, AQ, and SEG. All other variables remain significant with the exception of LOSS and audit committee EXP.

Table 7.6: ***Audit Fee Regression Models (n =945) (dependent variable is log audit fees)***

			Model A		**Model B**		
Variable	Sign	Hypo	Coefficient	t-value	Coefficient	t-value	VIF
Constant				35.816		33.116	
LTA	+		0.444	17.702***	0.416	17.793***	2.762
TA	+		0.032	1.506***	0.053	2.648***	1.994
LNAF	+		0.075	4.512**	0.061	3.930***	1.209
NAF	+		0.050	2.245**	0.076	3.652***	2.192
SUB	+		0.688	21.745***	0.699	23.802***	4.370
FOREIGN	+		0.257	8.371***	0.226	7.840***	4.206
SEG	+		0.051	2.975***	0.053	3.312***	1.276
ROA	-		-0.030	-1.533	-0.039	-2.121**	1.671
LEV	-		-0.070	-4.412***	-0.056	-3.766***	1.118
AQ	+		0.051	3.137**	0.062	4.040***	1.180
LOSS	+		0.004	0.210	0.001	0.028	1.671
PRD	+		0.070	2.432***	0.041	2.464*	1.400
PCON	+		0.040	2.272**	0.051	3.057**	1.410
IND	+				0.053	3.205***	1.387
DIL	+				0.069	4.406***	1.241
EXP	+				0.018	1.239	1.078
OBJ	+				0.055	3.322***	1.396
WP	+				0.124	7.452***	1.400
F-statistic				231.272		271.012	
p-value				0.000		0.000	
Adj. R^2				0.792		0.818	

p < 0.10; **p<0.05; ***p<0.01

ºObservations having a zero for LNAF are re-corded to a small positive value (0.00001) to enable a logarithmic transformation.

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non-audit fees (in RM) while LNAF is natural logarithm of non-audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; SEG is the number of business segments; ROA is net profit before tax over total assets; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to '1' if the firm has made loss in any of the years, '0' if otherwise; AQ an indicator variable equals to '1' if the firm hires Big4 auditor and '0' if otherwise; PRD an indicator variable equals to '1' for post-test period and '0' otherwise; PCON is an indicator variable '1', if PCON firms and '0' otherwise; IND is the proportion of independent non-executive directors to audit committee; DIL is the number of meetings; EXP is the number of audit committee with accounting or finance qualification; OBJ is an indicator variable, '1' if the internal audit function reports to audit committee, and '0' if otherwise; WP is the voluntary disclosure on IAF under Para 43 of SIC.

Table 7.6 - continued

			Model C								
			I			II			III		
Variable	Sign	Hypo	Coefficient	t-value	VIF	Coefficient	t-value	VIF	Coefficient	t-value	VIF
Constant				32.846			31.996			32.192	
LTA	+		0.418	17.825***	2.782	0.417	17.973***	2.762	0.405	17.381***	2.796
TA	+		0.055	2.739***	2.011	0.067	3.325***	2.060	0.050	2.551***	1.995
LNAF	+		0.060	3.868***	1.212	0.061	3.978***	1.209	0.062	4.030***	1.210
NAF	+		0.076	3.646***	2.192	0.085	4.072***	2.216	0.064	3.088***	2.232
SUB	+		0.699	23.811***	4.370	0.706	24.169***	4.384	0.715	24.357***	4.441
FOREIGN	+		0.227	7.866***	4.209	0.220	7.697***	4.217	0.233	8.144***	4.221
SEG	+		0.053	3.357**	1.278	0.057	3.589*	1.282	0.055	3.492***	1.278
ROA	-		-0.040	-2.175**	1.675	-0.038	-2.120**	1.671	-0.032	-1.769*	1.683
LEV	-		-0.057	-3.824**	1.122	-0.056	-3.794***	1.118	-0.050	-3.392**	1.128
AQ	+		0.061	3.989***	1.183	0.058	3.840***	1.184	0.063	4.134***	1.181
LOSS	+		0.001	0.045	1.672	0.002	0.090	1.673	0.000	0.019	1.671
PRD	+		0.043	2.587*	1.424	0.040	2.415*	1.400	0.040	2.455*	1.400
PCON	+		0.048	0.526	17.484	0.141	2.719*	8.391	0.186	5.140***	6.772
IND	+		-0.063	-3.336***	1.830	-0.046	-2.778*	1.404	-0.052	-3.191***	1.387
DIL	+		0.070	4.459***	1.245	0.015	0.564	3.621	0.081	5.118***	1.281
EXP	+		0.019	1.310	1.083	0.025	1.733	1.096	0.027	1.493	1.669
OBJ	+		0.053	3.142***	1.422	0.053	3.243***	1.397	0.059	3.561***	1.399
WP	+		0.123	7.390***	1.403	0.124	7.525***	1.400	0.125	7.567***	1.400
IND_PCON	+	2a	0.102	1.108	17.830						
DIL_PCON	+	2b				0.236	3.903***	8.750			
EXP_PCON	+	2c							0.161	4.195***	7.619

F-statistic	219.049	223.178	223.875
p-value	0.000	0.000	0.000
Adj. R^2	0.818	0.821	0.821

p < 0.10; **p<0.05; ***p<0.01

ºObservations having a zero for LNAF are re-corded to a small positive value (0.00001) to enable a logarithmic transformation.

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non-audit fees (in RM) while LNAF is natural logarithm of non-audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; SEG is the number of business segments; ROA is net profit before tax over total assets; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to '1' if the firm has made loss in any of the years, '0' if otherwise; AQ an indicator variable equals to '1' if the firm hires Big4 auditor and '0' if otherwise; PRD an indicator variable equals to '1' for post-test period and '0' otherwise; PCON is an indicator variable '1', if PCON firms and '0' otherwise; IND is the proportion of independent non-executive directors to audit committee; DIL is the number of meetings; EXP is the number of audit committee with accounting or finance qualification; OBJ is an indicator variable, '1' if the internal audit function reports to audit committee, and '0' if otherwise; WP is the voluntary disclosure on IAF under Para 43 of SIC.

Table 7.6 - continued

			Model C					
			IV			V		
Variable	Sign	Hypo	Coefficient	t-value	VIF	Coefficient	t-value	VIF
Constant				32.529			31.640	
LTA	+		0.409	17.509***	2.787	0.413	17.738***	2.766
TA	+		0.051	2.574***	1.995	0.057	2.895***	2.007
LNAF	+		0.063	4.072***	1.211	0.058	3.763***	1.214
NAF	+		0.082	3.955***	2.213	0.077	3.739***	2.193
SUB	+		0.711	24.109***	4.447	0.699	23.915***	4.370
FOREIGN	+		0.226	7.891***	4.206	0.222	7.716***	4.217
SEG	+		0.055	3.486***	1.280	0.055	3.483***	1.280
ROA	-		-0.038	-2.111*	1.671	-0.037	-2.046*	1.672
LEV	-		-0.061	-4.076***	1.130	-0.060	-4.020***	1.126
AQ	+		0.062	4.075***	1.181	0.060	3.965	1.182
LOSS	+		0.000	0.002	1.671	0.001	0.044*	1.672
PRD	+		0.042	2.544*	1.401	0.041	2.502*	1.400
PCON	+		0.045	1.271***	6.390	-0.110	-1.956*	6.058
IND	+		0.058	3.493***	1.399	0.054	3.259***	1.387
DIL	+		0.068	4.375	1.242	0.067	4.317***	1.243
EXP	+		0.020	1.406	1.081	-0.019	-1.327	1.079
OBJ	+		0.028	1.489***	1.797	0.055	3.341***	1.396
WP	+		0.119	7.161	1.413	0.089	4.434***	2.076
OBJ_PCON	+	3a	0.112	3.073***	6.801			
WP_PCON	+	3b				0.173	3.000***	6.993

F-statistic	221.472	221.340
p-value	0.000	0.000
Adj. R^2	0.820	0.820

****p* < 0.10; ***p*<0.05; ****p*<0.01**

ºObservations having a zero for LNAF are re-corded to a small positive value (0.00001) to enable a logarithmic transformation.

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non-audit fees (in RM) while LNAF is natural logarithm of non-audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; SEG is the number of business segments; ROA is net profit before tax over total assets; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to '1' if the firm has made loss in any of the years, '0' if otherwise; AQ an indicator variable equals to '1' if the firm hires Big4 auditor and '0' if otherwise; PRD an indicator variable equals to '1' for post-test period and '0' otherwise; PCON is an indicator variable '1', if PCON firms and '0' otherwise; IND is the proportion of independent non-executive directors to audit committee; DIL is the number of meetings; EXP is the number of audit committee with accounting or finance qualification; OBJ is an indicator variable, '1' if the internal audit function reports to audit committee, and '0' if otherwise; WP is the voluntary disclosure on IAF under Para 43 of SIC.

Model C brings in the interaction variables, political connections (PCON) which comprise of Models I, II, III, IV and V. Hypotheses 2a, 2b and 2c predict a stronger relationship between AC characteristics, IND, DIL and EXP with AF for PCON firms post-BMLR 2008. The results indicate that the interaction term audit committee DIL_PCON is significant at $p<0.01$, with coefficient (0.236) and t-value (3.903). It reveals that there is a stronger association between the audit committee DIL and audit fees for PCON firms for post-BMLR 2008 implementation, thus H2b is supported. This is because under the demand side perspective, audit committee members who meet frequently are more informed and knowledgeable about relevant accounting and auditing issues (Raghunadan *et al.,* 1998; Raghunadan and Hugh, 1994; Kalbers and Fogarthy, 1993; Goodwin and Kent, 2006).

Similarly, the coefficient on the interaction term EXP_PCON is positive and significant (0.161, t=4.195, $p<0.01$). This result is consistent with our expectation in Hypothesis 2c, which posits that the association between audit committee EXP and audit fees is stronger post-BMLR 2008. As supported by DeZoort (1997) and DeZoort and Salterio (2001), skilled audit committee members have a better understanding of the risks faced by the auditor.

Further, as reported by Botica, Redmayne, Bradbury and Cahan, (2011) that there is a positive association between audit committees and audit fees and the results are consistent with audit committees being an important monitoring mechanism. Hence, diligent and having financial expertise audit committee members who sit on PCON firm's board demand for substantive external audit work and are willing to pay higher audit fees. However, the results indicate that multicollinearity exists for the audit committee IND (VIF = 17.830), showing that independent variables are highly correlated. Thus, H2a is not supported.

Hypotheses 3a and 3b predict a stronger relationship between internal audit function attributes, OBJ and WP with AF for PCON firm's post-BMLR 2008 implementation. The coefficient on the interaction term OBJ_PCON is positive and significant (0.112, t=3.073, p<0.01). The results suggest that the association between objectivity and audit fees is stronger post-BMLR 2008, thus fully support H3a. The positive coefficient for the interaction variable indicating that the PCON firms' heads of internal audit reporting directly to the audit committee is stronger after the implementation of BMLR 2008.

A positive and significant result for WP_PCON and the audit fees at 1 percent significant level (0.173, t=3.000) is also observed, thus supporting H3b. It indicates that PCON firms disclose more information on internal audit activities under voluntary disclosure as per Para 43 of SIC. This confirms that the internal audit responsibility reflects the reporting relationships of IAF to audit committee and the role of audit committee in its oversight of IAF. The results are similar to the findings in Goodwin and Kent (2006) and Hay *et al.* (2008) that internal audit and external audit are complementary mechanisms within the governance framework. This is because external auditing standards permit external auditors to rely on the work of internal auditors in performing a financial statement audit to the extent that the internal auditors are competent, objective and also perform work that is relevant to the external audit (AICPA 1997; PCAOB 2007). The results also support the respondents' (EA3, IA3 and R1) opinions obtained in the present study that external auditors must be assured of the information and quality of the internal audit function before they can rely on the internal audit work.

Thus, it can also be said that the findings of this study correspond with the Transformation Program[20] which was introduced by the Malaysian government to enhance corporate governance, develop social leaders and clarify social obligations to steer the government-linked firms (in this study collectively referred to as PCON firms), particularly in upgrading the effectiveness of the board (Najid and Abdul Rahman, 2011). Further, the operational enhancement initiatives outlined in the Manual has already taken effect since it was introduced in 2005. This is part of the initiative taken by the regulatory institutions which is in line with the 'normative' isomorphism to inculcate good governance practices in the corporate sector. It is believed that the Program may have influenced the PCON firms as they are claimed to be favoured organizations by the government.

Besides that, the Green Book guidelines may have led the PCON firms to adopt stronger governance by enhancing board effectiveness (Khazanah's Green Book, 2006). Firms that are committed to strong corporate governance demand additional assurance from auditors and higher audit quality (Lifschutz *et al.*, 2010), and are likely to engage in greater levels of internal auditing resulting in higher external audit fees (Goodwin and Kent, 2006). This is because audit committee members who sit on PCON firm's board demand for expanded audit scope in order to avoid being associated with financial misstatement and to preserve their reputational capital. Hence, the PCON firm's audit committee members are committed to strong corporate governance. They are in place to monitor the management, who otherwise may act in their own personal best interest and not in the interest of the shareholders. It is also important to note that the association between the internal governance mechanisms of audit committee characteristics and internal audit function attributes, and audit fees from the demand side perspective is

[20] Catalyzing GLC Transformation to Advance Malaysia's Development, Section II-Policy guidelines; GLCs Transformation Manual.

addressed where it was found that stronger audit committee and internal audit function are associated with higher audit fees.

7.4 Model 2: Highly Regulated Firms (HRFs) and Less Regulated Firms (LRFs)

7.4.1 Descriptive Analysis

The sample consists of 1045 firm-year observations for 2005 to 2009. Table 7.7 provides the descriptive statistics for the variables in Model 2. On average, the sampled firms audit committee members are predominantly independent (IND) at 88.8 percent, diligent (DIL) in conducting meetings at an average of 5.28 and having at least 1.40 members with accounting or finance qualification (EXP). The mean for the voluntary disclosure on work performed (WP) and disclosed during the year by the internal audit department is 10.9 out of 19 voluntary disclosures as per Para 43 of *Statement of Internal Control* (SIC). Finally, 83 percent of the internal audit functions of the sample firms report directly to the audit committee (OBJ).

The mean audit fees (AF) is RM346,016.040 and it ranges from RM9,000 to RM6,172,000. The average client size (TA) is RM5,331,818, where else the mean for the variable indicating non-audit fees (NAF) is RM171,849. On average, the sample firms have 21.52 local subsidiaries (SUB), 2.16 foreign subsidiaries (FOREIGN) and 3.23 business segments. Further, the sample firms experience financial crisis (ZFC) at an average of -3.048, financial risk (ROA) at 0.054 and leverage (LEV) at 0.276. Seventy-one percent of the sample firms hire Big4 as external auditors and 18 percent of the firms encounter losses in any of the five (5) years.

7.4.2 Univariate Analysis

Table 7.8 provides descriptive statistics for the continuous and indicator variables. The descriptive analysis uses the paired t-tests to determine whether there are any significant differences for the sample and control sample for pre-test and post-test periods. The analysis includes the Univariate tests, t-tests and Pearson's correlation tests between the dependent variable (audit fees) and independent variables which consisted of audit committee characteristics and internal audit functions attributes.

Table 7.8 shows the differences in the means and medians between the variables during the testing periods. The results generally show significant differences for AF, IND, OBJ and WP. Audit fees increased from RM302,863 during the pre-test period to RM410,119 during the post-test period. The descriptive statistics also show that the average audit committee IND for the sample firms increased from 83.1 percent to 97.4 percent. It indicates that there is an increase in the proportion of independent non-executive directors in audit committee post-implementation of BMLR 2008. Similar evidence of significance was noted for internal audit function OBJ between the testing periods. The increase from 74 percent to 95 percent shows improvement in the number of heads of internal auditors who report directly to the audit committee.

Additionally, it is also observed that there is a significant difference on voluntary disclosures on activities performed by internal auditors. The number of voluntary disclosures records a higher score of 11.89 during the post-test period. There are no significant differences for the remaining variables.

Table 7.7: Descriptive statistics for the number of observations (Year 2005 – 2009, n = 1045)

Variable	*Minimum*	*Maximum*	*Mean*	*Median*	*Std. Dev*
LAF	9.100	15.640	12.067	11.905	1.054
AF	9000.000	6172000.000	346016.040	148000.000	630495.503
LTA	9.610	19.090	13.570	13.355	1.706
TA	14916.000	195674251.000	5331818.870	631492.000	18815259.909
LNAFº	9.210	15.910	4.708	9.615	9.314
NAF	0.000	8100000.000	171849.960	15000.000	593234.539
SUB	0.000	360.000	21.520	12.000	31.325
FOREIGN	0.000	109.000	2.160	0.000	8.755
SEG	1.000	8.000	3.230	3.000	1.642
ZFC	-4.994	-1.010	-3.048	-3.089	0.875
ROA	-.1989	0.1993	0.054	0.055	0.061
LEV	0.000	1.001	0.276	0.245	0.183
LOSS	0.000	1.000	0.180	0.000	*
AQ	0.000	1.000	0.710	1.000	*
IND	0.000	1.000	0.888	1.000	0.157
DIL	1.000	21.000	5.280	5.000	2.039
EXP	0.000	4.000	1.400	1.000	0.619
OBJ	0.000	1.000	0.830	1.000	*
WP	2.000	17.000	10.900	11.000	2.728

ºObservations having a zero for LNAF are re-coded to a small positive value (0.00001) to enable a logarithmic transformation. *not necessary

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non-audit fees (in RM) while LNAF is natural logarithm of non-audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; SEG is the number of business segments; ZFC is the Zmijewski score for financial crisis; ROA is net profit before tax over total assets; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to '1' if the firm has made loss in any of the years, '0' if otherwise; AQ an indicator variable equals to '1' if the firm hires Big4 auditor and '0' if otherwise; IND is the proportion of independent non-executive directors to audit committee; DIL is the number of meetings; EXP is the number of audit committee with accounting or finance qualification; OBJ is an indicator variable, '1' if the internal audit function reports to audit committee, and '0' if otherwise; WP is the voluntary disclosure on IAF under Para 43 of SIC.

Table 7.8: Descriptive data and paired t-tests results for pre-test period and post-test periods (n = 1045)

	(Year 2005 to 2007)			*(Year 2008 to 2009)*			
Variable	*Mean*	*Std. Dev*	*Median*	*Mean*	*Std. Dev*	*Median*	*t-tests/Chi-square*
LAF	11.970	1.032	11.805	12.212	1.072	12.083	-3.622*
AF	302863.470	513717.054	134000.00	410119.49	768273.778	177000.00	-2.490*
LTA	13.524	1.723	13.284	13.639	1.680	13.409	-1.055
TA	5520493.440	20166373.038	587845.000	5045793.78	16578265.208	666463.00	-0.395
LNAFº	4.375	9.449	9.546	5.207	9.096	9.830	-1.412
NAF	157224.420	503866.509	14000.000	193788.28	706511.090	18605.00	-0.974
SUB	20.720	12.000	30.443	22.720	32.603	13.000	-1.007
FOREIGN	2.050	8.538	0.000	2.320	9.080	0.000	-0.496
SEG	3.230	1.643	3.000	3.230	1.642	3.000	-0.023
ZFC	-3.032	0.869	-3.094	-3.072	0.885	-3.086	0.727
ROA	0.056	0.059	0.057	0.051	0.064	0.054	1.290
LEV	0.277	0.181	0.248	0.274	0.187	0.243	0.193
LOSS	0.180	*	0.000	0.180	*	0.000	©0.453
AQ	0.710	*	1.000	0.700	*	1.000	©0.395
IND	0.831	0.167	0.750	0.974	0.087	1.000	-17.941*
DIL	5.220	1.962	5.000	5.380	2.147	5.000	-1.183
EXP	1.380	0.610	1.000	1.420	0.631	1.000	-1.204
OBJ	0.740	*	1.000	0.950	*	1.000	©0.000*
WP	10.230	2.778	11.000	11.890	2.324	12.000	-10.422*

*****p<0.05;*** © Chi-square tests * not necessary

ºObservations having a zero for LNAF are re-coded to a small positive value (0.00001) to enable a logarithmic transformation.

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non-audit fees (in RM) while LNAF is natural logarithm of non-audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; SEG is the number of business segments; ZFC is the Zmijewski score for financial crisis; ROA is net profit before tax over total assets; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to '1' if the firm has made loss in any of the years, '0' if otherwise; AQ an indicator variable equals to '1' if the firm hires Big4 auditor and '0' if otherwise; IND is the proportion of independent non-executive directors to audit committee; DIL is the number of meetings; EXP is the number of audit committee with accounting or finance qualification; OBJ is an indicator variable, '1' if the internal audit function reports to audit committee, and '0' if otherwise; WP is the voluntary disclosure on IAF under Para 43 of SIC.

Table 7.9: Pearson Correlation Matrix for sample firms (Year 2005 – 2009, n = 1045)

	LAF	*AF*	*LTA*	*TA*	*LNAF*	*NAF*	*SUB*	*FOREIGN*	*SEG*	*ZFC*	*ROA*	*LEV*	*LOSS*	*AQ*	*REG*	*IND*	*DIL*	*EXP*	*OBJ*	*WP*
LAF	1	0.765**	0.781**	0.476**	0.346**	0.472**	0.679**	0.430**	0.443**	0.118**	0.059	0.090**	-0.109**	0.294**	0.278**	0.142**	0.340**	0.124**	0.161**	0.238**
AF		1	0.650**	0.619**	0.245**	0.671**	0.659**	0.532**	0.372**	-0.001	0.023	-0.024	-0.094**	0.165**	0.282**	0.146**	0.378**	0.089**	0.112**	0.152**
LTA			1	0.630**	0.309**	0.420**	0.510**	0.335**	0.362**	0.115**	0.016	0.154**	-0.135**	0.327**	0.420**	0.180**	0.329**	0.092**	0.122**	0.186**
TA				1	0.174**	0.365**	0.277**	0.205**	0.285**	-0.024	-0.077*	-0.046	-0.089**	0.143**	0.481**	0.131**	0.424**	0.104**	0.091**	0.154**
LNAF					1	0.286**	0.209**	0.159**	0.104**	0.045	0.074*	0.060	-0.057	0.238**	0.131**	0.141**	0.179**	0.083**	0.089**	0.116**
NAF						1	0.492**	0.581**	0.184**	-0.002	0.054	-0.016	-0.032	0.154**	0.132**	0.085**	0.298**	0.110**	0.084**	0.116**
SUB							1	0.811**	0.394**	0.044	0.095**	0.013	-0.062*	0.124**	0.000	0.081**	0.099**	0.143**	-0.014	0.010
FOREIGN								1	0.204**	-0.034	0.131**	-0.032	-0.051	0.103**	-0.015	0.067*	0.034	0.116**	-0.031	-0.013
SEG									1	0.026	-0.077*	0.014	-0.044	0.040	0.262**	0.024	0.112**	0.153**	0.008	0.061
ZFC										1	-0.260**	0.766**	0.251**	0.034	0.031	-0.060	0.018	-0.017	0.033	0.056
ROA											1	-0.091**	-0.580**	0.047	-0.160**	-0.006	-0.083**	0.037	-0.010	-0.053
LEV												1	0.125**	0.028	0.126**	-0.037	0.054	-0.071*	0.029	0.080*
LOSS													1	-0.075*	-0.050	0.005	-0.022	-0.016	0.023	0.003
AQ														1	0.137**	0.053	0.113**	0.004	-0.039	0.048
REG															1	0.164**	0.279**	0.029	0.107**	0.185**
IND																1	0.146**	0.052	0.246**	0.207**
DIL																	1	0.117**	0.071*	0.148**
EXP																		1	-0.033	0.057
OBJ																			1	0.486**
WP																				1

Significant at *10, **5 and ***1 per cent levels.

ºObservations having a zero for LNAF are re-coded to a small positive value (0.00001) to enable a logarithmic transformation.

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non-audit fees (in RM) while LNAF is natural logarithm of non-audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; SEG is the number of business segments; ZFC is the Zmijewski score for financial crisis; ROA is net profit before tax over total assets; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to '1' if the firm has made loss in any of the years, '0' if otherwise; AQ an indicator variable equals to '1' if the firm hires Big4 auditor and '0' if otherwise; REG an indicator variable equals to '1' if highly regulated firms and '0' if otherwise; IND is the proportion of independent non-executive directors to audit committee; DIL is the number of meetings; EXP is the number of audit committee with accounting or finance qualification; OBJ is an indicator variable, '1' if the internal audit function reports to audit committee, and '0' if otherwise; WP is the voluntary disclosure on IAF under Para 43 of SIC.

7.4.3 Correlation

Test of correlation is used to test the degree of relationships between the variables under study. The objective of the test is to see if there are any multicollinearity problems among the variables. Table 7.9 reports the correlations between the variables used in the regressions for Model 2. The table shows the correlation matrix between audit fees, control variables and experimental variables. From the table, audit committee IND, DIL and EXP have a positive and significant association with audit fees. Further, internal audit function attributes OBJ and WP are positively and significantly associated with audit fees.

Consistent with expectations, the correlation matrix also shows that the correlation coefficient between regulatory oversight (REG) and audit fees is positive and significant. Except for ROA, all other variables are significantly correlated with audit fees. The signs for the control variables are all in the right direction and significant in the testing periods except for the coefficient for LEV. Since none of the explanatory variables are highly correlated (r > 0.09), their correlations do not indicate that multicollinearity is a serious problem (Pallant, 2001).

7.4.4 T-tests and Chi-square Analysis for Highly Regulated Firms

Table 7.10 shows the results for the differences between HRFs and LRFs. The results generally highlight significant differences between the two groups except for SUB, FOREIGN, ZFC, LOSS, and EXP. The analytical procedure is applied to answer the third research question as to whether highly regulated firms pay higher audit fees than less regulated firms and to test the following hypothesis:

H4: Highly regulated firms pay higher audit fees than less regulated firms.

In comparison between the two groups, the AF is statistically different for both sub-sample firms at $p<0.05$significant level (t=-7.863). From the table, it shows that HRFs experience higher audit fees than LRFs (μ=RM903,547, μ=RM289,307), thus fully supporting H4. This could be explained by HRFs having larger client size (TA), hiring the Big4 auditor to audit their financial statements (AQ) and bigger business segments (SEG). Given the t-value of -8.134 with a significant level of $p<0.05$, the audit committee independence (IND) is statistically significant for both groups. From this data, it shows that HRFs have higher level of audit committee IND with a majority of audit committee members being non-executive directors. Additionally, the audit committee diligence (DIL) is also experiencing significant difference at $p<0.05$ with HRFs' audit committees meeting at an average of 7 times in a year as compared to LRFs which average 5.1 times in a year.

The internal audit WP during the year is significantly different at $p<0.05$ significant level for both HRFs and LRFs. However, as compared to LRFs, the HRFs internal audit functions voluntarily disclosed more information as per Para 43 of the SIC, on the activities performed. Similarly, OBJ also report significant differences between HRFs and LRFs in terms of internal audit function direct reporting to audit committee with HRFs scored 95 percent as compared to 81 percent for LRFs. Given that t=-2.860 with a significant level of $p<0.05$, the NAF is statistically significant for both groups. Client size measured by total assets (TA) is statistically significant for both subsamples at $p<0.05$. Additionally, comparable evidence of significance was noted for ROA, AQ and SEG at $p<0.05$ level of significance for both groups.

Table 7.10: T-tests and Chi-square results for Highly Regulated Firms and Less Regulated Firms for sample firms (Year 2005 – 2009, n = 1045)

Variable	*Highly Regulated Firms (n=100)*		*Less Regulated Firms (n=945)*		
	Mean	*SD*	*Mean*	*SD*	*t-value/ Chi-square*
LAF	12.988	1.217	11.974	0.990	-7.863*
AF	903547.370	1298763.043	289307.820	482894.925	-4.578*
LTA	15.934	1.902	13.353	1.513	-12.234*
TA	35233228.080	50925734.307	2590325.060	7852211.850	-5.938*
LNAFº	8.434	7.904	4.3117	9.368	-4.865*
NAF	411696.970	910871.080	146334.320	543279.994	-2.860*
SUB	21.490	21.723	21.520	32.183	0.010
FOREIGN	1.750	3.242	2.200	9.146	0.487
SEG	4.550	1.507	3.090	1.593	-8.752*
ZFC	-2.965	0.945	-3.056	0.868	-0.923
ROA	0.024	0.038	0.057	0.062	7.547*
LEV	0.347	0.300	0.268	0.164	-2.572*
LOSS	0.120	*	0.190	*	©0.130
AQ	0.900	*	0.690	*	©0.000
IND	0.967	0.093	0.880	0.160	-8.134*
DIL	7.030	3.971	5.100	1.608	-4.820*
EXP	1.450	0.626	1.390	0.618	-0.931
OBJ	0.950	*	0.810	*	©0.000*
WP	12.450	1.940	10.730	2.749	-8.040*

*p < 0.05 ºObservations having a zero for LNAF are re-coded to a small positive value (0.00001) to enable a logarithmic transformation. © Chi-square *not necessary

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non-audit fees (in RM) while LNAF is natural logarithm of non-audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; SEG is the number of business segments; ZFC is the Zmijewski score for financial crisis; ROA is net profit before tax over total assets; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to '1' if the firm has made loss in any of the years, '0' if otherwise; AQ an indicator variable equals to '1' if the firm hires Big4 auditor and '0' if otherwise; IND is the proportion of independent non-executive directors to audit committee; DIL is the number of meetings; EXP is the number of audit committee with accounting or finance qualification; OBJ is an indicator variable, '1' if the internal audit function reports to audit committee, and '0' if otherwise; WP is the voluntary disclosure on IAF under Para 43 of SIC.

7.4.5 Multivariate analysis

Multiple regression models was applied using SPSS regression between audit fees (AF) as the dependent variable and audit committee characteristics IND, DIL and EXP and internal audit functions attribute OBJ and WP as the experimental variable for HRFs and LRFs. Model 2 is as shown below:

$$AF = \beta_0 + \beta_1 TA + \beta_2 NAF + \beta_3 SUB + \beta_4 FOREIGN + \beta_5 SEG + ß_6 ZFC + ß_7 LEV + \beta_8 ROA + \beta_9\ LOSS + \beta_{10} PRD + \beta_{11} AQ + \beta_{12} REG + \beta_{13} IND + \beta_{14} DIL + \beta_{15} EXP + \beta_{16} OBJ + \beta_{17} WP + \boldsymbol{\beta_{18} IND\_REG + \beta_{19} DIL\_REG + \beta_{20} EXP\_REG + \beta_{21} OBJ\_REG + \beta_{22} WP\_REG} + \varepsilon,$$

Where:

AF	=	Audit fees paid by the client (Natural logarithm of audit fees).
TA	=	Total assets (Natural logarithm of total assets).
NAF	=	Total non-audit fees paid by client (Natural logarithm of NAF).
SUB	=	Number of client's local subsidiaries.
FOREIGN	=	Number of client's foreign subsidiaries.
SEG	=	Number of business segments.
ZFC	=	Zmijewski score for financial crisis[21].
ROA	=	Profit before tax over total assets.
LEV	=	Proportion of total liability over total assets.
AQ	=	An indicator variable equals to '1' if Big4 auditor, and '0' if otherwise.
LOSS	=	An indicator variable equals to '1' if the firm has made loss in any of the years and '0' if otherwise.
PRD	=	An indicator variable equals to '1' for post-test period and 0 if otherwise.
IND	=	Proportions of independent non-executive directors to AC.
DIL	=	Number of AC meetings.
EXP	=	Number of AC members with accounting or finance qualification.
OBJ	=	An indicator variable equals to '1' if head of internal audit function reports to audit committee and '0' if otherwise.
WP	=	Number of voluntary disclosure under IAF as per Para 43 of SIC.
IND_REG	=	Interaction between IND and REG.
DIL_REG	=	Interaction between DIL and REG.
EXP_REG	=	Interaction between EXP and REG.
OBJ_REG	=	Interaction between OBJ and REG.
WP_REG	=	Interaction between WP and REG.
ε	=	Error term.

[21] Zmijewski financial distress score: The model incorporates three weighted financial ratios taken from Zmijewski (1984).

4. Net income/Total assets (X_1)
5. Total debt/Total assets (X_2)
6. Current assets/Current liability (X_3)

The above ratios are used to compute the Zmijewski score using the following model:

$Z = 4.3 – 4.5\ X_1 + 5.7\ X_2 - 0.004\ X_3$

Table 7.11 describes the variables and the expected direction of the moderating effects of regulatory oversight and the association between the audit committee characteristics and internal audit function attributes and audit fees for HRFs and LRFs.

Table 7.11: Variables Description and Expected Direction for Model 2

Variable(s)	Description and Measurement	Exp Sign	Hypo
Dependent Variable			
AF	Audit fee paid by the client (Natural logarithm of audit fees used in regression model).		
Experimental Variables			
AC Characteristics			
IND	The proportion of independent non-executive directors to AC.	+	
DIL	Number of AC meetings	+	
EXP	Number of AC members with accounting or finance qualification.	+	
IAF Attributes			
OBJ	An indicator variable equals to'1' if the IAF reports directly to audit committee and'0' if otherwise.	+	
WP	Voluntary disclosure under IAF as per Para 43 of Statement of Internal Control (SIC).	+	
Control Variables			
TA	Total assets for client at the end of fiscal year (Natural logarithm of total assets).	+	
NAF	Total non-audit fee paid by client (Natural logarithm of non-audit fees).	+	
SUB	Number of client's local subsidiaries.	+	
FOREIGN	Number of client's foreign subsidiaries.	+	
SEG	Number of business segments.	+	
ZFC	Zmijewski scores for financial crisis.	+	
LEV	Proportion of total liability over total assets.	-	
ROA	Profit before tax over total assets.	-	
LOSS	An indicator variable equals to '1' if the company has made loss in any of the periods and '0' if otherwise.	+	
AQ	An indicator variable equals to '1' if the firm hires Big4 auditor and 0 if otherwise.	+	
PRD	As an indicator variable, '1' for post-test period, and '0' if otherwise.	+	
IND_REG	Interaction between IND and REG.	+	H5a
DIL_REG	Interaction between DIL and REG.	+	H5b
EXP_REG	Interaction between EXP and REG.	+	H5c
OBJ_REG	Interaction between OBJ and REG.	+	H6a
WP_REG	Interaction between WP and REG.	+	H6b

Table 7.12 presents the multiple regression results for testing the hypotheses. Models A, B and C are significant at one percent significant level (*p*=0.000) with an adjusted R^2 of at least 76 percent. With the exception of FOREIGN, the signs and significance (p<0.05 or lower) of the coefficients on the control variables across the three models are in predicted directions. Overall, the data suggests the models are structurally stable.

The results in Model A show the association between external audit fees on eleven (11) control variables derived from the extant literature (Gul, 2006; Boo and Sharma, 2008; Yatim *et al.,* 2006; Abdul Wahab *et al.,* 2009). Following prior research (Simunic, 1980; Francis and Simon, 1987; Craswell *et al.,* 1995), it is expected that the audit fees are positively associated with total assets (TA), non-audit fees (NAF), number of local subsidiaries (SUB), number of business segments (SEG), number of foreign subsidiaries (FOREIGN), financial crisis index (ZFC), and audit quality (AQ). All other variables remain significant with the exception of LOSS. The TA being the most dominant determinant of audit fees, is positive and significant at one percent level of significance (0.460, *t*=18.145), indicating that the bigger the size of audit client firms' the higher the audit fees charged by the external auditors.

The coefficient of NAF (0.064, *t*=3.896) is also significant and positive at p<0.01. Moreover, audit complexity measured by SUB, FOREIGN and SEG coefficient is found to be positive and significant at one percent significant level. Prior research expect that the more complex an audit client, the harder it is to audit and the process requires more time (Simunic, 1980; Hackenbrack and Knechel, 1997).

Similarly, ZFC coefficient is positively and significantly associated with higher audit fees at p<0.01, suggesting that the auditors may be exposed to higher risk if the audit client is badly affected by the financial crisis. ROA is negatively significant at one percent level ($p<0.01$), indicating the extent to which the auditor may be exposed to higher risk in the event that the audit client is not financially viable (Simunic, 1980). LEV is also negatively significant at one percent level ($p<0.01$). It is another measure of risk of a client failing, which potentially exposes the auditor to loss (Simunic, 1980). AQ is positively associated with audit fees which strongly support the observation that the Big4 is associated with higher audit fees. PRD which reports on post-BMLR 2008 implementation also shows positive and significant results and higher audit fees.

A positive and significant ($p<0.01$) coefficient on REG is also observed. This is to confirm that HRFs pay comparatively higher audit fees than LRFs, which is inconsistent with the prior study by Boo and Sharma (2008) who find a negative association between HRFs and audit fees. This argument is consistent with the notion that regulatory oversight complements the external audit monitoring, hence higher audit fees. The extensiveness of the external audit is higher in HRFs with stronger corporate governance than LRFs. This is because the audit committee members demand for extensive audit test even though HRFs have stronger internal controls and internal monitoring.

Table 7.12: ***Audit Fee Regression Models (n =1045) (dependent variable is log audit fees)***

			Model A		**Model B**		
Variable	Sign	Hypo	Coefficient	t-value	Coefficient	t-value	VIF
Constant				34.781		32.319	
LTA	+		0.460	18.145***	0.449	18.331**	2.840
TA	+		0.015	0.706***	0.050	2.322**	2.157
LNAF	+		0.064	3.896***	0.058	3.611***	1.204
NAF	+		0.118	5.819***	0.076	3.808***	1.894
SUB	+		0.554	17.392***	0.554	18.124***	4.419
FOREIGN	+		-0.278	-9.399***	-0.241	-8.376***	3.910
SEG	+		0.078	4.382***	0.082	4.750***	1.400
ZFC	+		0.101	3.966***	0.107	4.379***	2.840
ROA	-		-0.064	-3.179***	-0.073	-3.757***	1.770
LEV	-		-0.081	-3.250***	-0.101	-4.151***	2.783
LOSS	+		0.011	0.554	0.013	0.725	1.635
AQ	+		0.060	3.621***	0.062	3.917***	1.190
PRD	+		0.082	5.398***	0.045	2.408***	1.369
REG	+		0.054	2.802***	0.070	4.120**	1.646
IND	+				-0.059	-3.473***	1.367
DIL	+				0.107	6.280***	1.362
EXP	+				-0.013	-0.897	1.071
OBJ	+				0.044	2.551***	1.400
WP	+				0.082	4.726***	1.437
F-statistic			238.663		196.589		
p-value			0.000		0.000		
Adj. R^2			0.767		0.759		

p < 0.10; **p<0.05; ***p<0.01

ºObservations having a zero for LNAF are re-coded to a small positive value (0.00001) to enable a logarithmic transformation.

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non-audit fees (in RM) while LNAF is natural logarithm of non-audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; SEG is the number of business segments; ZFC is the Zmijewski score for financial crisis; ROA is net profit before tax over total assets; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to '1' if the firm has made loss in any of the years, '0' if otherwise; AQ an indicator variable equals to '1' if the firm hires Big4 auditor and '0' if otherwise; REG an indicator variable equals to '1' if highly regulated firms and '0' if otherwise; IND is the proportion of independent non-executive directors to audit committee; DIL is the number of meetings; EXP is the number of audit committee with accounting or finance qualification; OBJ is an indicator variable, '1' if the internal audit function reports to audit committee, and '0' if otherwise; WP is the voluntary disclosure on IAF under Para 43 of SIC.

Table 7.12 - continue

Model C

			I			II			III		
Variable	Sign	Hypo	Coefficient	t-value	VIF	Coefficient	t-value	VIF	Coefficient	t-value	VIF
Constant				32.219			32.455			32.282	
LTA	+		0.449	18.263**	2.851	0.460	18.632***	2.900	0.452	18.436***	2.847
TA	+		0.049	2.281**	2.172	0.077	3.307***	2.565	0.061	2.761***	2.313
LNAF	+		0.058	3.624***	1.207	0.058	3.679***	1.204	0.056	3.535***	1.206
NAF	+		0.076	3.803***	1.894	0.080	4.016***	1.903	0.081	4.024***	1.921
SUB	+		0.554	18.119***	4.423	0.559	18.318***	4.431	0.558	18.247***	4.443
FOREIGN	+		-0.241	-8.380***	3.913	-0.246	-8.579***	3.927	-0.244	-8.489***	3.923
SEG	+		0.082	4.752***	1.401	0.082	4.764***	1.400	0.078	4.491***	1.420
ZFC	+		0.107	4.366***	2.842	0.111	4.551***	2.849	0.104	4.217***	2.858
ROA	-		-0.073	-3.753***	1.770	-0.072	-3.730***	1.770	-0.071	-3.652***	1.775
LEV	-		-0.100	-4.136***	2.786	-0.100	-4.147***	2.783	-0.098	-4.035***	2.793
LOSS	+		0.014	0.729	1.635	0.014	0.753	1.635	0.012	0.651	1.637
AQ	+		0.062	3.925***	1.191	0.061	3.869***	1.190	0.062	3.929***	1.190
PRD	+		0.070	4.121***	1.369	0.069	4.056***	1.370	0.069	4.057***	1.371
REG	+		0.101	0.683	3.804	0.041	1.174	5.692	0.022	0.573	7.054
IND	+		-0.058	-3.366***	1.403	-0.058	-3.400***	1.368	-0.059	-3.478***	1.367
DIL	+		0.107	6.287***	1.372	0.071	3.411***	2.063	0.109	6.393***	1.366
EXP	+		-0.014	-0.898	1.071	-0.009	-0.594	1.083	-0.023	-1.446	1.174
OBJ	+		0.043	2.507**	1.410	0.045	2.605***	1.400	0.044	2.543***	1.400
WP	+		0.083	4.739***	1.444	0.083	4.765***	1.437	0.083	4.785***	1.438

IND_REG	+	5a	0.057	0.383	5.240						
DIL_REG	+	5b				0.119	2.934***	7.883			
EXP_REG	+	5c							0.078	1.985**	7.285
F-statistic				188.627			188.619			187.509	
p-value				0.000			0.000			0.000	
Adj. R²				0.787			0.787			0.786	

p < 0.10; **p<0.05; ***p<0.01

ºObservations having a zero for LNAF are re-corded to a small positive value (0.00001) to enable a logarithmic transformation.

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non-audit fees (in RM) while LNAF is natural logarithm of non-audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; SEG is the number of business segments; ZFC is the Zmijewski score for financial crisis; ROA is net profit before tax over total assets; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to 1 if the firm has made loss in any of the years, 0 if otherwise; AQ an indicator variable equals to 1 if the firm hires Big4 auditor and 0 if otherwise; PRD an indicator variable, 1 for post test period and 0 otherwise; REG an indicator variable, 1 for regulated, and 0 otherwise: PRD an indicator variable equal to 1 for post-test period and 0 otherwise; IND is the proportion of independent non-executive directors audit committee; DIL is the number of meetings; EXP is the number of AC with accounting or finance qualification; OBJ is an indicator variable, 1 if the internal audit function reports to audit committee, and 0 otherwise; WP is the voluntary disclosure on IAF under Para 43 of SIC; IND_REG is an interaction term; DIL_REG is an interaction term; EXP_REG is an interaction term; OBJ_REG is an interaction term; WP_REG is an interaction term;

Table 7.12 continue

Model C

Variable	Sign	Hypo	IV Coefficient	IV t-value	IV VIF	V Coefficient	V t-value	V VIF
Constant				32.161			32.192	
LTA	+		0.451	18.424**	2.846	0.449	18.321**	2.840
TA	+		0.046	2.166**	2.171	0.050	2.322**	2.158
LNAF	+		0.057	3.555***	1.205	0.058	3.605***	1.205
NAF	+		0.077	3.835***	1.894	0.076	3.792***	1.903
SUB	+		0.554	18.135***	4.419	0.554	18.089***	4.430
FOREIGN	+		-0.241	-8.396***	3.911	-0.241	-8.353***	3.924
SEG	+		0.081	4.706***	1.401	0.082	4.747***	1.402
ZFC	+		0.103	4.188***	2.865	0.107	4.371***	2.855
ROA	-		0.071	3.698***	1.772	0.073	3.754***	1.775
LEV	-		-0.098	-4.027***	2.795	-0.101	-4.150***	2.786
AQ	+		0.012	0.657***	1.637	0.014	0.726***	1.636
LOSS	+		0.062	3.885	1.190	0.062	3.908	1.192
PRD	+		0.071	4.195***	1.371	0.070	4.116***	1.370
REG	+		0.160	2.513***	7.229	0.038	0.405	6.426
IND	+		-0.062	-3.613***	1.375	-0.059	-3.472***	1.367
DIL	+		0.106	6.240***	1.363	0.107	6.265***	1.365
EXP	+		-0.014	-0.913	1.071	-0.013	-0.894	1.072
OBJ	+		0.049	2.817***	1.434	0.044	2.551**	1.402
WP	+		0.083	4.740***	1.437	0.082	4.622***	1.492
OBJ_REG	+	6a	0.121	1.890**	7.445			
WP_REG	+	6b				0.007	0.077	6.994
F-statistic			187.422			186.573		
p-value			0.000			0.000		
Adj. R^2			0.786			0.786		

p < 0.10; **p<0.05; ***p<0.01 ºObservations having a zero for LNAF are re-coded to a small positive value (0.00001) to enable a logarithmic transformation.

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non-audit fees (in RM) while LNAF is natural logarithm of non-audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; SEG is the number of business segments; ZFC is the Zmijewski score for financial crisis; ROA is net profit before tax over total assets; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to '1' if the firm has made loss in any of the years, '0' if otherwise; AQ an indicator variable equals to '1' if the firm hires Big4 auditor and '0' if otherwise; REG an indicator variable equals to '1' if highly regulated firms and '0' if otherwise; IND is the proportion of independent non-executive directors to audit committee; DIL is the number of meetings; EXP is the number of audit committee with accounting or finance qualification; OBJ is an indicator variable, '1' if the internal audit function reports to audit committee, and '0' if otherwise; WP is the voluntary disclosure on IAF under Para 43 of SIC.

Model B introduces the audit committee characteristics namely IND, DIL and EXP and internal audit function attributes OBJ and WP. The results show that the coefficients on audit committee DIL is positive and significant ($p<0.01$), and the coefficient on IND is significant but in the opposite direction. In addition, the coefficient on audit committee EXP is not significant. The coefficient on REG remains positive and significant. The findings on audit committee DIL are consistent with the demand-based argument that diligent audit committee provides more vigilant oversight of the financial reporting process and demand for additional assurance from external auditors to protect their reputational capital. Evidence consistent with this view is provided by Carcello *et al.* (2002) and Abbott *et al*. (2003). Similarly, the coefficient on internal audit function attributes, namely OBJ and WP, are also significant at ($p<0.01$). These findings are consistent with prior studies that investigate less regulated firms, generally find evidence supporting a positive association between internal audit and external audit fees (Adams *et al.,* 1997; Deis and Giroux, 1996; Anderson and Zeghal, 1994). Thus, it can be concluded that the heads of internal audit of HRFs report directly to audit committee and disclose more information on internal audit activities as per voluntary disclosure under Para 43 of SIC. The results suggest that the introduction of the BMLR 2008 have instigated greater audit effort and have increased the audit fees for HRFs.

Model C brings in the interaction variables and to test the hypotheses. It comprises of five individual Models I, II, III, IV and V on audit committee characteristics and internal audit function attributes and their interactions with regulatory oversight. The interaction term DIL_REG (audit committee diligence by regulatory oversight) examining the impact of BMLR 2008 is positive and significant (0.119, t=2.934, $p<0.01$). The positive coefficient for the interaction variable reveals a stronger positive relationship between DIL and higher audit fees moderated by regulatory oversight, after the BMLR revision in 2008. It shows that HRFs are complying with the new requirements. This result is consistent with our expectation in Hypothesis 5b, which posits that regulatory oversight strengthens the association between audit committee DIL and higher audit fees. Similarly, the coefficient on the interaction term EXP_REG (audit committee expertise by regulatory oversight) is positive and significant (0.078, t=1.985, p<0.05). This result is consistent with the expectation in Hypothesis 5c, which posits that industry-specific regulatory oversight strengthens the association between audit committee EXP and higher audit fees. Further, as noted by the interviewees (IA1, IA2, IA3, EA2, EA3, R1 and R2) in the present study (see Chapter 6, Section 6.5), the role of regulators in Malaysia is very effective. All eight respondents agreed that the industry-specific regulator which is the Bank Negara Malaysia (BNM) is very much involved in enforcing tighter regulations, thus firms in highly regulated industry are more governed as compared to other. This is also in line with the Guidelines on Corporate Governance for Licensed Institutions issued by Bank Negara Malaysia in 2004 that the audit committees of financial firms shall comprise of non-executive directors with at least three members, of which the majority should be independent directors. At least one member should have accounting expertise or experience in the field of finance. Further, the guidelines also emphasised that the committee should hold regular meetings, at least once every quarter and should report regularly to the full board.

Finally, the coefficient on the interaction term OBJ_REG (internal audit function objectivity by regulatory oversight) is positive and significant (0.121, t=1.890, p<0.05). The results suggest that regulatory oversight strengthens the association between objectivity and higher audit fees, thus fully supporting H6a. The positive coefficient for the interaction variable indicates that the head of internal audit reporting directly to the audit committee is stronger post-implementation of BMLR 2008. Hence, this complies with the Guidelines on Corporate Governance for Licensed Institutions by Bank Negara Malaysia (2004) which emphasised on the direct authority and supervision of the audit committee. Besides that, this finding is also consistent with the comprehensive disclosure requirements for better understanding of the financial and management position of the HRFs, particularly in relation to its internal governance practices. The remaining of the interaction variables term IND_REG, and WP_REG is insignificant and thus, do not support H5a and 6b.

It is important to note that the results on the interaction variables on audit committee characteristics, internal audit functions attributes and higher audit fees post-BMLR 2008 observed above are consistent with the demand side explanation of the audit fee phenomenon. It suggests that enhanced governance practices by the audit committee members and internal auditors, seek higher audit quality. Such greater assurance provided by the external auditor requires additional audit work which is reflected in higher audit fees. Since one of the primary responsibilities of the audit committee is to review and monitor the audit process, active and independent audit committees can influence the extent of the audit (DeZoort, 1997). Hence, we find that industry-specific regulatory oversight influences audit fees and the association between internal governance mechanisms and audit fees. We attribute the higher audit fees paid by HRFs to the role of the regulatory oversight function as complement, not a substitute, for external audit monitoring.

7.4.6 Sensitivity Analyses

In Model 1, a linear regression model was tested by including audit committee characteristics namely independence, diligence and expertise, and internal audit function attributes, namely objectivity and work performance, and their interactions variables in Model 1 (PCON) and Model 2 (REG). The results show that the VIFs are greater than 10 for AC independence (VIF = 17.830) and multicollinearity exists for Model 1. Thus, the experimental variables are being interacted independently with the moderating variables in the respective models. Further, the Zmijewski score (ZFC) to control for financial crisis is removed from the regression analysis for Model 1. This is because the inclusion of this variable has contributed to the positive effect of ROA in the Model, since ROA is part of ZFC variable.

In Model 2, Mann Whitney U-test was also conducted to further extend the basic findings. Since the sample size for highly regulated firms is small of only 20 firms (equivalent to 100 firm-year observations), a non-parametric statistical tool is also used. Previous studies that use similar matched pairs method are Beasley (1996), Carcello and Nagy (2004b), Farber (2005), Gul (2006), Owens-Jackson, Robinson and Shelton, (2009), Zhao and Chen (2009), and Mustafa and Youssef (2010). Gul (2006) compares 38 firms with political connections to 206 firms without political connections and Nelson (2010) uses 28 fraud firms to be matched with 84 non-fraud firms. This is because the number of firms of interest is usually not large. This is consistent with prior studies such as Johnson and Mitton (2002) at 72, Gul (2006) at 43, and Abdul Wahab *et al.* (2009) at 90. The idea is to test whether the results differ from the t-tests analysis as shown in Table 7.10. However, insignificant difference to the results was observed. (Mann Whitney U test results are attached in Appendix E).

7.5 Interpretation of Results

The summary of the results is tabulated in Table 7.13. The first hypothesis predicts that PCON firms pay higher audit fees than non-PCON firms. The second and third hypotheses for Model 1 examine the moderating effect of political connections on the association between audit committee characteristics and internal audit function attributes, and audit fees post-BMLR implementation for PCON firms. The results show that the PCON firms have higher audit fees due to the enhanced internal governance mechanisms and greater increase in audit effort. Similarly, stronger and positive association between audit committee DIL_PCON and EXP_PCON, and audit fees post-BMLR 2008 implementation was reported. Further, stronger and positive association between internal audit function attributes namely OBJ_PCON and WP_PCON, and audit fees post-BMLR 2008 implementation was also evidenced. It suggests that audit committee members induce firms to purchase high quality audit service in order to reduce the likelihood of fraudulent financial reporting (Abbott *et al.,* 2003; Carcello *et al.,* 2002). However, this study does not find support for the audit committee IND_PCON.

Table 7.13: Summary of Findings

	PCON Firms		**HRFs**	
Dependent Variable: Audit Fees	(H1) Higher Audit fees	- Supported	(H4) Higher Audit fees	- Supported
Independent Variables:	(H2a) Independence	- Not Supported	(H5a) Independence	- Not Supported
Audit Committee	(H2b) Diligence	- Supported	(H5b) Diligence	- Supported
	(H2c) Expertise	- Supported	(H5c) Expertise	- Supported
Internal Audit Function Attributes	(H3a) Objectivity	- Supported	(H6a) Objectivity	- Supported
	(H3b) Work Performance	- Supported	(H6b) Work Performance	- Not Supported

Further, the inclusion of political embeddedness perspective explains the political relationships between the PCON firms and the government. The government took proactive steps to dispel the negative perceptions of its favoured firms to enhance board effectiveness and revamp board practices and processes (Khazanah's Green Book, 2006). Thus, corporate governance does matter for politically connected firms as suggested by Chan *et al.* (2012).

Further, for Model 2, hypothesis 4 predicts that HRFs have higher audit fees than LRFs. The fifth and sixth hypotheses predict that audit committee characteristics and internal audit function attributes, moderated by regulatory oversight have a positive association with higher audit fees for HRFs. The results show that HRFs pay higher audit fees due to an additional industry-specific regulator i.e. Bank Negara Malaysia, which requires more audit effort, thus an increase in audit fees. Similarly, regulatory oversight strengthens the association between audit committee DIL and EXP, with higher audit fees for HRFs. Additionally, regulatory oversight strengthens the association between internal audit function attributes OBJ and higher audit fees. This is consistent with the notion that regulatory oversight complements the external auditing as monitoring mechanisms. This also supports Adams and Mehran (2003) that the boards of directors of HRFs are placed in a crucial role in the governance structure. Although the boards of HRFs are assigned the same legal responsibilities as the boards of LRFs, regulators have placed additional expectations on HRFs, resulting in the boards delineating their responsibilities even further. Consequently, the internal governance mechanisms quality will impact the quality of corporate governance (Gramling *et al.*, 2004). Therefore, it can be concluded that firms that are committed to strong corporate governance are likely to engage in greater levels of internal auditing and are willing to pay for a higher quality external audit (Goodwin and Kent 2006). However, this study does not find any support for internal audit function namely WP. It suggests that HRFs have disclosed most of the voluntary disclosures under Para 43, as they are required to provide the audit committee members with information needed for decision making and target setting.

The application of institutional theory in this research supports the argument that an institution plays an important role in monitoring the operation of the firms. In addition, the establishment of regulatory agencies helps to promote corporate governance best practices, formulating and enforcing the accounting standards applicable to listed firms. Further, it can be said that the additional-specific regulator i.e. BNM has put high expectations on HRFs, resulting in the audit committee and internal audit department taking a more pro-active and independent role in the monitoring process.

7.6 Conclusion

This chapter presents the results of the data analysis to test the six hypotheses developed in Chapter 4. Both Model 1 and Model 2 in this study used multiple regression statistical techniques. The results for Model 1 indicate that hypotheses 1, 2b, 2c, 3a and 3b are significant in the predicted direction. However, for hypothesis 2a, the results reveal high correlation among the independent variables thus multicollinearity exists. Further, for Model 2, the linear regression was executed to examine the moderating effect of regulatory oversight on the association between AC characteristics and IAF attributes, and audit fees. The results indicate that hypotheses 4, 5b, 5c, and 6a are significant in the predicted direction. The results of most control variables are consistent with prior studies. The next chapter will provide the conclusion for the study.

Chapter 8 CONCLUSIONS

8.1 Introduction

This final chapter synthesises the discussion in the earlier chapters and focuses specifically on the contributions arising from this study. Further, the chapter identifies some of the limitations of research and provides suggestions for future research.

8.2 Summary of Research

The main objective of this study is to further the understanding of the association between the internal governance mechanisms of audit committee and internal audit function, and audit fees in the context of an emerging economy that has an institutional setting that differs from most developed western economies. The revision of the Bursa Malaysia Listing Requirements in 2008 (BMLR 2008) to enhance the internal governance mechanisms of firms provides a fitting opportunity to examine audit fees from the demand side perspective. Thus, this study investigates the impact of the revised BMLR 2008 pertaining to audit committee characteristics and internal audit function attributes on audit fees. The uniqueness of the Malaysian corporate setting with the presence of favoured firms or politically connected (PCON) firms and the stringent regulatory oversight by the Bank Negara Malaysia (BNM) over financial institutions and insurance firms further motivated this study to examine the moderating effects of political connection and regulatory oversight on the association between the audit committee characteristics and internal audit function attributes, and audit fees.

Based on the afore-mentioned objectives, this thesis focused on four (4) research questions: First, do PCON firms pay higher audit fees than non-PCON firms; secondly, is the association between the internal governance mechanisms of audit committee characteristics and internal audit function attributes, and audit fees stronger post-BMLR

2008 implementation for PCON than non-PCON firms; thirdly, do highly regulated firms (HRFs) pay higher audit fees than low regulated firms (LRFs); and fourthly, is the association between the internal governance mechanisms of audit committee characteristics and internal audit function attributes, and audit fees stronger post-BMLR 2008 implementation for HRFs than LRFs.

Three (3) theories namely the agency theory, political embeddedness perspective and institutional theory are applied to examine and explain the relationship between the above said internal governance mechanisms and audit fees. To answer the four research questions mentioned above, two research models were developed. Model 1 focuses on the moderating effect of political connections on the association between audit committee characteristics and internal audit function attributes, and audit fees. Model 2 examines the moderating effects of regulatory oversight on the association between the said internal governance mechanisms and audit fees.

Twelve (12) hypotheses were developed and empirically tested to give a better impression of the breadth of this study. The audit committee characteristics were measured by the constructs of independence, diligence and expertise. While the internal audit functions attributes were measured using the constructs of objectivity and work performance.

The majority of the hypotheses were supported by this study. Particularly, for Model 1 hypotheses 1, 2b, 2c, 3a and 3b, while for Model 2 hypotheses 4, 5b, 5c and 6a were supported. Three (3) out of 12 hypotheses (i.e. hypotheses 2a, 5a and 6b) were not supported. The results clearly indicate that PCON firms have higher audit fees than non-PCON firms due to enhanced governance and greater increase in audit effort. The association between audit committee diligence and expertise, and audit fees is stronger post-BMLR 2008 implementation for PCON firms. Similar results are also evidenced for internal audit function attributes, of objectivity and work performance, and audit fees, suggesting that firms with higher audit fees are more likely to use greater level of internal auditing.

The results also show that highly regulated firms have higher audit fees due to additional industry-specific regulator which requires more audit effort, thus increase in audit fees. Similarly, regulatory oversight strengthens the association between audit committee diligence and expertise, and higher audit fees. Regulatory oversight also strengthens the association between internal audit function attributes of objectivity and higher audit fees. This is consistent with the notion that regulatory oversight plays a vital role in corporate governance and complements the external audit as monitoring mechanisms.

This current study draws on the agency theory, political embeddedness perspective and institutional theory. According to the agency theory, the separation of ownership and control between the owner and manager of a firm would subsequently lead to agency costs, such as audit fees. As managers may not act in the best interests of shareholders, monitoring by independent directors is crucial. The importance of the agency theory in corporate governance is further supported by the findings of this research, which applies an agency theory framework, that the improved internal governance mechanisms through enhanced audit committee characteristics and internal audit function attributes increase the demand for audit procedure resulting in higher audit fees.

In addition, the higher audit fees for the government favoured PCON firms may be explained from the political embeddedness perspective. To dispel the negative perceptions of PCON firms, the Malaysian government implemented steps to enhance their corporate governance. The results of this study shows the PCON firms have better governance mechanisms, indicating the success of the Transformation Program to boost the firms' corporate governance.

Further, the institutional theory that theorised an important role for regulators to ensure firms comply with rules and regulation supports Model 2 of this study. Financial institutions and insurance firms in Malaysia have unique operating and financial structure, different reporting requirements and are subject to an additional industry-specific regulator which is the Bank Negara Malaysia. Specifically, these firms have to comply with the regulations from both the Bank Negara Malaysia and the Bursa Malaysia. The role and responsibility of the BNM as an industry-specific regulator institutionalizes good practices have proven to be important in enhancing the functions and effectiveness of corporate governance in these highly regulated firms.

8.3 Contributions of the Study

The contributions of the study are discussed below.

8.3.1 Theoretical Contributions to Theory Development

The findings of the present study make several contributions to theory development. Past researches on audit fees are generally drawn upon the traditional agency literature which explains the role of board of directors in monitoring and controlling a firm. Although this present study finds the agency theory is relevant to explain the role of audit committee as a monitoring mechanism, this study shows that additional theory is needed to explain the relationships between the government and its favoured firms.

Thus, this research introduces the politically embeddedness perspective which elucidates the political relationship between the government and the politically connected firms.

The application of political embeddedness perspective in this research is a key contribution to extant literature. The inclusion of political embeddedness perspective explains the political relationships between the PCON firms and the government. Since PCON firms are generally perceived to exhibit poor corporate governance and greater agency problems, this study evidenced that corporate governance does matter in the case of PCON firms where they are committed to strong corporate governance practices and engaged in greater levels of internal auditing and are prepared to pay for a higher quality external audit work.

Further, prior studies on PCON firms have generally drawn on the supply based perspective suggesting a supply–side explanation for audit fees in the absence of a strong corporate governance regime. However, this study reveals that good corporate governance practices had been effectively implemented in PCON firms and the demand side explanation should prevail.

In addition, given the absence of corporate governance research in regulated environment, the investigation as to how highly regulated firms are impacted by the BMLR 2008 practices are timely. The findings suggest that audit committees of HRFs demand extensive external audit due to stringent regulatory oversight by an additional industry-specific regulator, Bank Negara Malaysia. This supports the assumption of the institutional theory on the role of regulators in promoting governance practices. Further, the findings also suggest that the BNM has achieved a high level of efficiency and effectiveness in performing its supervisory role to formulate regulatory framework and conduct oversight function over accounting matters by enforcing good corporate governance practices on HRFs. Hence, an industry-specific regulatory oversight also plays an important role in the development of good corporate governance.

In conclusion, this study which combines the agency theory, politically embeddedness perspective and institutional theory has contributed to the extant audit fees literature.

8.3.2 Theoretical Contributions to Research Design

This research introduces new measurement for the work performance of internal audit functions. Instead of using internal audit size to measure the contribution of the internal audit function as was done in previous studies, this study adopts the measures in SAS No. 65 adopted in the US. Voluntary disclosures on internal audit function activities is introduced as the measurement for the quality of work performance.

The present study also contributes to the extant literature by providing evidence using both archival and primary data from Malaysia to study the impact of the enhanced Bursa Malaysia Listing Requirements in 2008 on audit committee characteristics and internal audit function attributes on audit fees. The findings add to research evidence from a country with a developing capital market which has less transparent and weaker corporate governance structures as compared to developed economies such as the US, UK and Australia. In addition, this research also answers to the call for research on highly regulated industries and from countries with developing capital market such as Malaysia.

8.3.3 Contributions to Practice and Policy Making

From the practical perspective, the findings of this research provide feedback to the regulators (i.e. Bursa Malaysia, Bank Negara Malaysia and Securities Commission) on ensuring policies that support and enhance the link between the internal governance mechanisms and external auditing. This study provides further understanding on the impact of audit committee characteristics and internal audit function attributes on audit fees. Past research was conducted before the revision of the BMLR 2008 and thus it is important to the regulators to appreciate the impact of the revision on audit fees. The findings of this study support the claim in the World Bank 2012 that enhanced reforms since 2008 have been effectively implemented by listed firms. Further, it may also assist regulators as well as policy makers in implementing further enhancements as recommended in the Malaysian Code of Corporate Governance 2012 and BMLR 2012.

In addition, past researches on PCON firms are drawn from the supply-side perspective and this present study thus extends the current knowledge and explores the demand side explanation by investigating the internal governance mechanisms' impact post-BMLR 2008 implementation for different types of ownership structured firms and highly regulated firms. The findings of this study also suggest that internal audit and external audit are complementary mechanisms within the governance framework. These findings will assist the regulators in understanding the effects of regulation on corporate governance, and by providing evidence to the external auditors and auditing standard setters that internal audit complements external auditing.

8.4 Limitations of Research

Notwithstanding the contributions mentioned above, the present study has a number of limitations that should be noted, hence providing opportunities for further research. The main limitations are elaborated below.

8.4.1 Highly Regulated Firms

With regards to the study on highly regulated firms, it is acknowledged that the number of HRFs in the sample is small, only 20 HRFs from approximately 831 Malaysian listed firms at the time of data collection (as at 6 January, 2011). However, this is the whole population of HRFs and the sample size is adequate for many statistical analyses since the sampled firms are taken for five years which is equivalent to 100 firm-year observations.

8.4.2 Qualitative Evidence

Eight (8) interviews were conducted with selected regulators, external auditors and heads of internal audit to elicit their perceptions and to obtain a better understanding on the enhanced corporate governance as well as auditing process and their implications on audit fees. The evidence served to highlight the problems and indicate possible explanation to the results of the analyses of the secondary data. However, richer insights could have been obtained by interviewing audit committee members and other senior management of selected firms. It would provide a thorough understanding of the corporate governance issues and the enhanced corporate governance of audit committee characteristics and internal audit function attributes on audit fees.

8.4.3 Measurement for IA Function Attribute - Competency

Another limitation of this study pertains to internal audit function attributes. Though this study adopts the measures in SAS No. 65 which comprised of objectivity, competency and work performance, competency was not measured. This is because there is no available data for internal audit function attribute, competency at the time of the research.

8.5 Future Research

Given the evidence presented in this thesis, there are several avenues for future research.

8.5.1 Bursa Malaysia Listing Requirements 2012

This study is based on the BMLR 2008. With the revision of the MCCG in 2012, the BMLR was further revised in November 2012. Although the requirement on audit committee characteristics and internal audit function attributes were not raised, there are now additional requirements on CG such as the establishment of a nomination committee. They will take effect only in 2013. Future research should examine the new changes extensively and their relation to audit fees. Besides that, a longitudinal study, expanding more than five years as pre-test and post-test periods would be beneficial in measuring the long-term impact of internal governance mechanisms on audit fees.

8.5.2 Audit Fees Comparison in the Same Region

In order to compare the level of audit fees with other countries in the same region, future research should also explore the feasibility of conducting research in countries such as Thailand, Singapore or Indonesia. The comparison across jurisdictions would also improve the robustness of the findings.

8.5.3 Relationships between Audit Committee and Heads of Internal Auditor

Past research on audit fees highlights that independent audit committee's demand for high level of assurance and at the same time support the external auditor's demand for substantive audit testing, consequently higher audit fees. Further, audit committee members with financial expertise will have a better understanding on auditing issues and the risks associated with a lower audit quality. Higher level of interactions between the audit committee members and the head of internal audit and also the external auditors in terms of frequent meetings, ensure that the audit committee will be well informed and more diligent in carrying out its duties. However, the present study has not looked at these relationships. Future research should look at these relationships and how these relationships would affect audit fees in Malaysia.

8.5.4 External Auditors Reliance on Internal Audit Contributions

The present research examined the complementary effect between external auditing and internal auditing. Firms with strong corporate governance practices are likely to engage in greater levels of internal auditing and are willing to pay for a higher quality of external audit work. However, this study has not looked at the external auditor's reliance on internal audit contributions. Future research should also look at the external auditor's reliance on internal audit contributions and to what extent this reliance has an impact on audit fees.

8.5.5 Political Embeddedness Perspective

The political embeddedness perspective has two dimensions. First, it looks at the firms' ownership and directorship of government officials in the PCON firms. Secondly, the appointment of former Big4 auditors to various positions in the audit client's firms. As this study only examines the first dimension on ownership and directorship of government official under political influence, future research should look at both dimensions as it will draw on the concept of political embeddedness as a whole.

8.5.6 Ownership Structured Firms

Another issue of interest is to further categorise the non-PCON firms into INSTITUTIONAL, MANAGERIAL and FAMILY ownership structured firms by conducting an ANOVA with post-hoc comparisons. This is to determine whether there are any significant differences between the means of independent (unrelated) groups.

8.5.7 Audit Committee Characteristics and Internal Audit Attributes

As this study separates the audit committee characteristics into independence, diligence and expertise and internal audit function attributes into objectivity and work performance, future research should combine the audit committee characteristics and internal audit function attributes. It can be done by allocating points for firms that meet 'best practice' criteria.

8.6 Conclusion

This chapter has summarized the research findings, overviewed its main limitations and noted some avenues for future research. It is evidenced that internal corporate governance mechanisms such as audit committee characteristics namely independence, diligence and expertise and internal audit function attributes namely objectivity and work performance also influence audit fees. The application of the political embeddedness perspective and institutional theory provides significant explanations to the audit fees phenomenon in the Malaysian context.

Clearly, this study shows that audit committee members have a duty not just to oversee the conduct of business in compliance with laws they should also be effective stewards and guardians of the firm in respect of ethical values, and to ensure an effective governance structure for the appropriate management of risks and level of internal controls. The enhanced corporate governance regime post-2008 has been effective in that politically connected firms and highly regulated firms still pay higher audit fees even though their internal governance mechanisms are stronger, indicating the dominance of the demand-side explanation compared to pre-2008 studies that highlighted a supply-side perspective. This observation strengthens claims that the corporate governance regulatory has indeed been effective. This study also facilitates to dispel the concerns regarding politically connected firms in the corporate governance reform efforts as highlighted in the World Bank Report in 2012.

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APPENDIX A

Prudential Financial Policy Development
Guidelines on Corporate Governance for Licensed Institutions
BNM/RH/GL 001-1

COMPLIANCE REQUIREMENTS

1.12 All Licensed Institutions are expected to:

(i) Comply and observe the Guidelines; and

(ii)Disclose in the annual report, any non-observance of the Guidelines and provide explanation and alternative measures taken to comply with the principles of the Guidelines.

AUDIT COMMITTEE

Objective

13. To provide independent oversight of the licensed institution's financial reporting and internal control system and ensuring checks and balances within the licensed institution.

Composition

14. The Audit Committee shall comprise ***only non-executive directors*** with ***at least three members***, of which the ***majority*** should be ***independent directors***. The committee should be ***chaired by an independent director***. At least one member should have ***accounting expertise or experience in the field of finance***.

Roles and Responsibilities

15. The Audit Committee should have explicit authority to investigate any matter within its terms of reference, full access to and co-operation by management and full discretion to invite any director or executive officer to attend its meetings, and reasonable resources to enable it to discharge its functions properly. The Audit Committee should have full and unrestricted access to information and be able to obtain independent professional advice. Duties of Audit Committee, among others, are as follows:

Fair and transparent reporting

- Ensure fair and transparent reporting and prompt publication of the financial accounts.

Effectiveness of Internal Audit

- Oversee the functions of the Internal Audit department and ensuring compliance with *BNM/GP10* requirement;
- Review the scope of the internal audit programme, internal audit findings and recommend actions to be taken by management; and Appoint, set compensation, evaluate performance and decide on the transfer and dismissal of the Chief Internal Auditor.

Internal Controls

- Review the effectiveness of internal controls and risk management processes.

External Auditors

- Select external auditors for appointment by board;
- Recommend not only the appointment but also the removal of auditors;

- Assess objectivity, performance and independence of external auditor (for example by reviewing and assessing the various relationships between the external auditor and the licensed institution or any other entity);
- Review the external auditor's management letter and response;
- Approve the provision of non-audit service by the external auditor;
- Ensure that there are proper checks and balances in place so that the provision of non-audit services does not interfere with the exercise of independent judgement of the auditors;
- Regularly review the audit findings and ensuring that issues are being managed and rectified appropriately and in a timely manner; and Have direct communication channels with the external auditors and able to meet with the external auditor without the presence of management, at least annually.

Related Party Transactions

- Review all related party transactions and keep the board informed of such transactions.

16. The committee should hold regular meetings, at least ***once every quarter*** and should report regularly to the full board.

INTERNAL AUDIT FUNCTION

Major Responsibilities of the Board

2.10 The major responsibilities of the boards of Licensed Institutions include:

Set up an effective internal audit department, staffed with qualified internal audit personnel to perform internal audit functions, covering the financial and management audit.

Adequate internal controls and strong risk management system within the Licensed Institution must be supplemented by an effective internal audit function that provides an independent evaluation on the adequacy of, and compliance with the established policies and procedures. To enhance the independence of the internal auditors in achieving their audit objectives, the board should ensure that the internal auditors have full access to all records, and are given an appropriate standing in the organisation's hierarchy.

Internal Audit

2.98 The internal audit function is an important part of any effective internal control and risk management system because it provides an independent assessment of the adequacy of, and compliance with, established policies and procedures. In addition, internal auditors should review and evaluate the reliability, adequacy and effectiveness of the Licensed Institution's internal control. The scope of internal audit should cover both financial and management audit. The nature of the internal audit role makes it critical that internal audit personnel is independent from the day-to-day activities of the Licensed Institution, and have unrestricted access to all activities conducted by the Licensed Institution. Direct accountability to the board facilitates the proper functioning of corporate governance by enabling the internal auditor to provide the board with information that is not biased as a result of interference by line or senior management. The importance of the internal audit function to the corporate governance process also requires it to be adequately resourced and staffed with competent and well-trained officers.

2.99 The internal audit function should be well placed to undertake investigation on behalf of the Audit Committee, thus internal auditors should have an appropriate standing within the institution and ***be placed under the direct authority and supervision of the Audit Committee***. The internal auditors should have access to the Audit Committee at all times. Since the internal auditors are held accountable to the Audit Committee, their performance and remuneration package should be evaluated and decided by the Audit Committee.

Principle 13: Conducting corporate governance in a transparent manner can reinforce sound corporate governance

Comprehensive Disclosure Requirement

2.108 To facilitate market discipline and sound corporate governance, ***appropriate disclosure is required*** so that shareholders, other stakeholders and market participants can effectively have an understanding of the financial and management position of the Licensed Institution, particularly in relation to its safety and soundness.

Licensed Institutions are required to observe the "Revised Guidelines on Financial Reporting for Licensed Institutions" (BNM/GP8), on a comprehensive disclosure requirement by Bank Negara Malaysia. Components of the corporate governance disclosure shall, at a minimum, comprise the following:

7) Internal Audit and Control Activities

- A review of the effectiveness of the key internal control policies and procedures established for managing daily activities and the changes made to the policies and procedures during the year to ensure that they remain relevant;
- The review should include the internal audit structure put in place to provide an independent assessment of the adequacy of, and compliance with established policies and procedures, the lines of reporting of the internal audit division, the functions, role and responsibilities of the internal audit division as well as the scope and nature of audit work; and
- Discussion should also include the procedures used to report internal control deficiencies or breaches, any potential trends identified on the control issues and any preventive actions that were taken.

UNIVERSITY OF MALAYA

The Leader in Research & Innovation

May 19, 2011

TO WHOM IT MAY CONCERN

Dear Sir/Madam,

This is to certify that **NORZIATON ISMAIL KHAN**, IC/ Passport No. **721008-14-5010**, Matric No. **CHA080026** is a student pursuing the Doctor of Philosophy (PhD) at the Faculty of Business and Accountancy, University of Malaya, Kuala Lumpur.

We would be grateful if you could provide her with the necessary assistance and cooperation to enable her to collect the data required for the above purpose.

Thank you.

Yours sincerely,

(ABDUL RANI HAJI ALIAS)
Assistant Registrar
Graduate School of Business
Faculty of Business and Accountancy
University of Malaya

Graduate School of Business
Level 4, Blok C, City Campus University of Malaya, Jalan Tun Ismail, 50480 Kuala Lumpur, Malaysia
Tel: (603) 2617 3008 / 2617 3051 / 2617 3052 • Fax: (603) 2617 3050 • Website: www.um.edu.my/FPP

APPENDIX C

Informed Consent Form

Title: Internal Governance Mechanisms and Audit Fees in Malaysia

This research is being undertaken for a dissertation as part of a doctoral program in the Faculty of Business and Accountancy at University of Malaya.

Purpose of the study:

To determine the effects of regulatory oversight on audit committee (AC) roles and internal audit function (IAF) before and after the revised Bursa Malaysia Listing Requirements 2008 (BMLR). This study would also investigate the impact of the amended BMLR on audit fees for high regulated industries and less regulated industries.

Participation:

During the interview, the interviewee will be asked questions with regards to his/her knowledge and experience on auditing specifically focusing on regulation, AC and IAF. However the interviewee is free to expand on the topic or talk about related ideas. The interview should take less than an hour and the conversation will be recorded as to avoid any missing out important comments or inadvertently change of words somehow. The interviewee may refrain from answering any questions or may end the interview at any time.

Potential Risks:

There should not be any risks borne by the interviewee during the interview. However, if there is any question or discussion that is considered personal or sensitive, the interviewee may decline to answer them.

Potential Benefits:

By understanding the effects of regulatory oversight to corporate governance key players, it helps to improve the effectiveness of the internal control of an organization. This study will be useful to regulators, academicians and practitioners. This study may provide some insights on the need for policies and regulation in order to enhance the link between the audit committee and the internal audit function. In addition, the knowledge is also important to practitioners in charging an appropriate amount of audit fees to companies.

Confidentiality:

All data will be treated as private and confidential. Only the interviewer and the mentioned below advisors will have access to this information. Upon completion of this research, all data will be stored in a secure place. Any information that is included in the study does not identify specific interviewee as the respondent and the participation in this study is completely voluntary.

Participant Certification:

I have read this Consent and Authorization form. I agree to take part in this study as a research participant. I am aware that my participation in this interview is voluntary. I have had the opportunity to ask, and I have received answers to, any questions I had regarding the study. I understand the intent and purpose of this study. If, for any reason, at any time, I wish to stop the interview, I may do so without having to give an explanation.

Participant Signature: ______________________________________Date: _____________________

Researcher Contact Information:

Norziaton Ismail Khan
Principal Investigator
Faculty of Business and Accountancy
University of Malaya
Kuala Lumpur
016-6607802
zie_khan@yahoo.com

AP Dr. Susela Devi
Faculty Advisor
Faculty of Business and Accountancy
University of Malaya
Kuala Lumpur
03-7967 3803
susela@um.edu.my

Dr Chan Wai Meng
Faculty Advisor
Faculty of Business and Accountancy
University of Malaya
Kuala Lumpur
03-79673890
chanwm@um.edu.my

Internal Governance Mechanisms and Audit Fees in Malaysia

Semi-Structured Interview Guide

Interview Guide Format:

Section A: Background Information
Section B: Internal Governance Mechanisms
Section C: Regulatory Oversight and Audit Fees
Section D: High Regulated and Less Regulated Industries

Organization: ______________________________

Interview Date: ______________________________

Section A: Background Information

Gender

Male
Female

Age Group

Below 26	46-50
26- 30	51-55
31-35	56-60
36-40	Above 60
41-45	

Education

Doctorate	Diploma
Master's Degree	Professional Cert (e.g. CPA, CIA)
Bachelor's Degree	Others (specify__________________________)

Professional Membership

None	IIAM
MIA	Others (specify__________________________)
MICPA	

Type of industry employed in:

Agriculture/Forestry/ Fisheries	Wholesale and retail trade
Mining	Services
Contract construction	Others (specify___________________________)
Manufacturing	
Transport, communication and utility services	

Tenure in current organization

Less than 2 years	6 to 10 years
2 to 5 years	11 years of more

Section B: Internal Governance Mechanisms (AC & IAF)

1. How would you describe the auditing regulation in Malaysia?
2. Can you explain how does the revised Bursa Malaysia Listing Requirements (BMLR) 2008 affect the role of audit committee and internal audit function?
3. Can you explain how does the revised Bursa Malaysia Listing Requirements 2008 affect the job function of an external auditor?
4. In your opinion, does an external auditor rely upon IAF activities?
5. To what extend an external auditor can rely on the IAF activities?

Section C: Politically Connected (PCON) Firms and Non-Politically Connected (NPCON) Firms

1. PCON firms are perceived to have poor corporate governance and riskier than non-PCON firms?
2. In your opinion, do the enhanced CG on AC and IAF attribute affecting PCON the most?
3. In your opinion do PCON firms complying with the BMLR 2008 even before it became mandatory by Bursa Malaysia?

Section D: High Regulated Firms (HRFs) and Less Regulated Firms (LRFs)

1. In your opinion, do you think that high regulated firms in Malaysia are more govern compared to less regulated firms?
2. High regulated firms are being charged with higher or lower audit fees compared to less regulated firms?
3. How do you perceived the role of an additional specific-industry regulator?

Section E: Audit Fees

1. In your opinion, do the enhanced in CG (AC and IAF) have any impact on audit fees?
2. In your opinion is the audit fee charged by external auditors is appropriate?

APPENDIX D

Descriptive statistics for the years 2005 to 2009

	Year 2005		*Year 2006*		*Year 2007*		*Year 2008*		*Year 2009*	
Variable	*Mean*	*Median*	*Mean*	*Median*	*Mean*	*Median*	*Mean*	*Median*	*Mean*	*Median*
LAF	11.787	11.676	11.888	11.744	11.982	11.846	12.028	11.925	12.160	12.025
AF	288128.400	754862.261	306756.80	126000.000	339398.840	142000.000	340284.140	153000.000	443792.420	167000.000
LTA	13.2389	13.076	13.271	13.065	13.348	13.118	13.385	13.110	13.427	13.126
TA	2225159.430	484252.000	2806703.61	473147.000	2704357.850	511063.000	2814154.810	498855.000	2916607.400	505049.000
LNAFº	2.483	9.105	3.087	9.210	4.155	9.392	4.227	9.488	4.427	9.680
NAF	143590.810	9000.000	176032.87	10000.000	140873.260	12000.000	221612.560	13200.000	166356.840	16000.000
SUB	20.140	12.000	20.420	12.000	21.580	12.000	22.350	13.000	23.120	13.000
FOREIGN	1.940	0.000	2.040	0.000	2.260	0.000	2.370	0.000	2.390	0.000
SEG	3.090	3.000	3.090	3.000	3.090	3.000	3.090	3.000	3.100	3.000
ZFC	-3.002	-3.076	-3.041	-3.094	-3.106	-3.098	-3.032	-3.049	-3.101	-3.069
ROA	0.053	0.054	0.056	0.061	0.068	0.071	0.058	0.063	0.051	0.056
LEV	0.277	0.242	0.267	0.249	0.261	0.248	0.274	0.253	0.262	0.2403
LOSS	0.220	0.000	0.200	0.000	0.130	0.000	0.220	0.000	0.160	0.000
AQ	0.690	1.00	0.700	1.000	0.690	1.000	0.690	1.000	0.670	1.000
PCON	0.350	0.000	0.305	0.000	0.350	0.000	0.350	0.000	0.350	0.000
INST&MGRL	0.280	0.000	0.280	0.000	0.280	0.000	0.290	0.000	0.290	0.000
FAMILY	0.360	0.000	0.360	0.000	0.360	0.000	0.360	0.000	0.360	0.000
IND	0.786	0.750	0.793	0.750	0.877	0.750	0.954	1.000	0.988	1.000
DIL	5.020	5.000	5.040	5.000	5.070	5.000	5.240	5.000	5.130	5.000
EXP	1.360	1.000	1.370	1.000	1.390	1.000	1.420	1.000	1.410	1.000
OBJ	0.650	1.000	0.680	1.000	0.840	1.000	0.930	1.000	0.960	1.000
WP	9.610	10.000	9.890	10.000	10.630	11.000	11.450	12.000	12.070	12.000

$*p < 0.05$; © Chi-square tests for dichotomous variables; t-tests for other variables ºObservations having a zero for LNAF are re-coded to a small positive value (0.00001) to enable a logarithmic transformation. *not necessary

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non-audit fees (in RM) while LNAF is natural logarithm of non-audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; SEG is the number of business segments; ZFC is the Zmijewsk financial crisis; ROA is net profit before tax over total assets; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to '1' if the firm has made loss in any of the years, '0' if otherwise; AQ an indicator variable equals to '1' if the firm hires Big4 auditor and '0' if otherwise; INST&MGRL is an indicator variable '1', with reference to PC otherwise; FAMILY is an indicator variable '1', with reference to PCON and '0' otherwise; IND is the proportion of independent non-executive directors to audit committee; DIL is the number of meetings; EXP is the number of audit committee with accounting or finance qualification; OBJ is an indicator variable, '1' if the internal audit reports to audit committee, and '0' if otherwise; WP is the voluntary disclosure on IAF under Para 43 of SIC.

APPENDIX E

Mann Whitney U Test results for High Regulated Firms and Less Regulated Firms for sample firms (2005 – 2009, n = 1045)

	High Regulated Firms (n=20)		*Less Regulated Firms (n=189)*		
Variable	*Mean*	*SD*	*Mean*	*SD*	*z-statistic*
LAF	12.988	1.217	11.974	0.990	-8.010*
AF	903547.370	1298763.043	289307.820	482894.925	-8.010*
LTA	15.934	1.902	13.353	1.513	-10.986*
TA	35233228.080	50925734.307	2590325.060	7852211.850	-10.986*
LNAFº	8.434	7.904	4.311	9.368	-6.243*
NAF	411696.970	910871.080	146334.320	543279.994	-6.243*
SUB	21.490	21.723	21.520	32.183	-0.170
FOREIGN	1.750	3.242	2.200	9.146	-1.483
SEG	4.550	1.507	3.090	1.593	-8.113*
ZFC	-2.965	0.945	-3.056	0.868	-0.347
ROA	0.024	0.038	0.057	0.062	-7.426*
LEV	0.347	0.300	0.268	0.164	-0.570
LOSS	0.120	0.327	0.190	0.389	0.130
AQ	0.900	0.302	0.690	0.463	0.000*
IND	0.967	0.093	0.880	0.160	-5.179*
DIL	7.030	3.971	5.100	1.608	-4.832*
EXP	1.450	0.626	1.390	0.618	-0.883
OBJ	0.950	0.219	0.810	0.390	0.000*
WP	12.450	1.940	10.730	2.749	-6.141*

* $P < 0.05$

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non audit fees (in RM) while LNAF is natural logarithm of non audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; SEG is the number of business segments; ZFC is the Zmijewski score for financial crisis; ROA is net profit before tax over total assets; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to 1 if the company has made loss in any of the years, 0 otherwise; AQ an indicator variable equals to 1 if the company hire Big4 auditor and 0 otherwise; REG an indicator variable, 1 for regulated, and 0 otherwise; IND is the proportion of non executive directors to audit committee; DIL is the number of meetings; EXP is the number of AC with accounting or finance qualification; OBJ is an indicator variable, 1 if the internal audit function reports to audit committee, and 0 otherwise; WP is the voluntary disclosure on IAF under Para 43 of SIC.