THE IMPACT OF CORPORATE GOVERNANCE PRACTICES ON AUDIT QUALITY IN MALAYSIAN PUBLIC LISTED COMPANIES

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A Thesis Submitted to Asia e University in Fulfilment of the Requirements for the Degree of Doctor of Philosophy

May 2016

ABSTRACT

Audit committees are tasked to protect investor interests by taking the lead on oversight responsibilities in audit activities, particularly to preserve audit quality. Its main role is governed by regulatory requirements of the relevant authorities within the regional and corporate governance codes. This thesis examines the influence of corporate governance practices on audit quality in Malaysian Public Listed Companies.

Audit committee effectiveness is used as a proxy of corporate governance practices and audit fee and non-audit service fee are used as proxies of audit quality. 457 listed companies are selected as the sample of the study. Data was obtained from annual reports of companies filed with Bursa Malaysia Resource Center. Pooled ordinary least square regression analysis is used to predict the audit fee and non-audit service fee based on effectiveness of audit committees, factors that related to board of directors and company related factors to explore various relationships between best practices of corporate governance and audit quality.

The research results show that all hypotheses have not been supported, suggesting that the effectiveness of audit committee has no significant impact on audit quality. The outcome, targeting the regulators to improve the quality of corporate governance, suggests a scrutiny of existing audit mechanism and focus area of audit function to ensure that gaps in the audit processes are bridged between the audit committee and the audit quality. The recommended actions for future research is to look at the relationship between audit committee and its terms of reference which possibly can be a limitation parameter that affects the efficacy of corporate governance quality.

APPROVAL PAGE

I certify that I have supervised /read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in quality and scope, as a thesis for the fulfilment of the requirements for the degree of Doctor of Philosophy.

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DECLARATION

I hereby declare that the thesis submitted in fulfilment of the PhD degree is my own work and that all contributions from any other persons or sources are properly and duly cited. I further declare that the material has not been submitted either in whole or in part, for a degree at this or any other university. In making this declaration, I understand and acknowledge any breaches in this declaration constitute academic misconduct, which may result in my expulsion from the programme and/or exclusion from the award of the degree.

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ACKNOWLEDGEMENTS

This thesis would never have been completed without the kind and unreserved help of several individuals to whom I wish to express my sincere gratitude. Firstly, I would like to extend my deepest gratitude to Dr Oo Yu Hock, my principal supervisor, who has provided trust, support, time, and excellent guidance during my study.

Secondly, I would like to thank Asia e University (AeU) for giving me this opportunity to complete my PhD successfully, by conducting research workshops and colloquiums to enable me to upgrade my knowledge on research processes.

Thirdly, I would like to thank Mr. Tee Chwee Ming, Dr Quah Kheng Siong, Dr Jasmine Lau, Dr Maran Marimuthu, Dr Rosnah Matzin and Dr Effiezal Aswadi Abdul Wahab for their friendship, comments, advice and support over the period of this study.

Finally, I would like to express my deepest gratitude and my special thanks to my husband, Kwong Chee Kueng; my daughter, Kwong Ying Hui; and my son, Kwong Wei Hong for their unending patience and tolerance over the period of study. Thank you for your support and for being there to encourage and assist me all the way along.

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CHAPTER 1

INTRODUCTION

This chapter begins with a background study and discusses the problems in relation to the research topic. The purpose of this study, includes a discussion of the study's main aim as well as a summary of the research objectives and research questions, followed by an explanation of the contribution which this research makes to the understanding of the governance role of audit committees. The final section of this chapter presents an overview of the structure of the thesis.

1.1 Background of the Study

In the 1970s, after a series of corporate failures, the regulators in the United States of America (US) recommended that listed firms should possess an independent audit committee, followed by the United Kingdom (UK), which recommended that all listed companies establish properly constituted audit committees in 1992, which was viewed as an important step in raising standards of corporate governance. In Asia, in a continuing effort to promote sound corporate governance; Malaysia (Shamsul, 2002), Hong Kong (Hong Kong Society of Accountants, 2002) and Singapore (Company (amendment) Act 1989, Section 201B) have introduced the requirements for an audit committee to all public-traded companies in 1993, 1995 and 1989 respectively. The failure of Enron in 2001 initiated a significant number of additional audit committee regulations both in the US and elsewhere. In the US, Sarbanes-Oxley Act of 2002 was introduced in 2003 which requires the audit committee to be fully independent (US House of Representatives, Committee on Financial Services, 2002, Section 301(3)). In the UK, the Smith Report (2003, p.3) which came into effect on 1 July 2003, provided guidance to company boards in making suitable arrangements for their audit committees and also assist directors serving on audit committees in performing their role (Zaman et al., 2011). In Malaysia, amendments to the audit committee requirements were recommended in 2007. The amendments spell out the eligibility criteria for appointment as an audit committee member, the composition of the audit committee, the frequency of meetings and the need for continuous training (Securities Commission, 2007). An overview of audit committee requirements in selected countries are included in Appendix A.

Corporate governance reforms concerning the effectiveness of boards and audit committees are intended to improve financial reporting and audit quality (Beasley et al., 2009; Cohen et al., 2004; Conyon, 2000; Krishnan and Visvanathan, 2009; Larcker and Richardson, 2004 and Peasnell et al., 2005). Effective boards and audit committees are expected to lead to a higher transparency and reliability of financial statements as well as reduce the risk of the auditor providing an incorrect audit opinion (McElveen, 2002; Turley and Zaman, 2004 and Young, 2000). Moreover, they are expected to protect auditor independence by assuming responsibility for the appointment and remuneration of auditors, and providing an independent platform for auditors to express their opinions on management policies. Thus, such corporate governance reforms not only have implications for audit quality but also on auditor remuneration, i.e. audit fee and non-audit service fee.

Audit committees are viewed as an important monitoring mechanism of corporate governance to improve the quality of the statutory audit process. Regulators and policy-makers from various countries have continuously improved their corporate governance framework, particularly on audit committees, to promote and sustain a strong culture of corporate governance. Despite their rigorous efforts, the number of corporate scandals associated with corporate governance problems in the first decade of 21st century is extensive (Da Silveira, 2013). The latest corporate scandals involving allegations of unethical behavior acting within or on behalf of a corporation, include Tesco PLC in the UK (UK Financial Reporting Council, 2014) and Banco Espirito Santo in Portugal (Kowsmann et al., 2014).

The development of audit committees in Malaysia began in 1991 (Haron, Jantan and Eow, 2005). The formation of audit committees in all the Malaysian public listed companies has become a listing requirements of the KLSE or Kuala Lumpur Stock Exchange - now renamed as Main Market Listing Requirements of Bursa Malaysia Securities Berhad since 1 August 1993 (KLSE, 1993, S15A). In response to the financial scandals in Malaysia over the past two decades, regulators and policy-makers have continuously enhanced the corporate governance framework to strengthen the operations of the corporate governance systems of the country (Table 1.1).

Table 1.1 Malaysian Code on Corporate Governance and Listing Requirements

	Code on Corporate Governance and Listing Requirements	Date
1	Malaysian Code on Corporate Governance 2000 (The Code)	March 2000
2	2001 Listing Requirements of KLSE	June 2001
3	2005 Listing Requirements of Bursa Malaysia Securities Berhad	January 2005
4	2006 Listing Requirements of Bursa Malaysia Securities Berhad	May 2006
5	Malaysian Code on Corporate Governance Revised 2007 (2007 Code)	October 2007
6	2009 Listing Requirements of Bursa Malaysia Securities Berhad	2009

Source. Extract from Bursa Malaysia Resource Centre on August 24, 2015

The new regulatory framework has made the audit committee the key governance mechanism, given that it is an essential component in the structure of public listed companies. As a result, the roles and responsibilities of the audit committee have increased tremendously (see Table 1.2). However, the majority of audit committee members in Malaysia feel that they may face difficulties in discharging their responsibility within a more stringent regulation and complex environment (Izma, 2013). Furthermore, the new regulatory governance framework has not prevented the recurrences of corporate governance scandals in the country as shown in Table 1.3. Relatedly, therefore, a continuing research on audit committee effectiveness is essential to explore the deficient issues of corporate governance and to arrest the occurrence of corporate scandals in future.

In this study, the researcher uses audit committee effectiveness as a proxy of corporate governance best practice and auditor remuneration which is used as a proxy of audit quality. The audit committee effectiveness is based on a composite measure of four dimensions, namely the diligence of audit committees (frequency of audit committee meetings), the size of audit committees, the financial expertise of audit committees and the independence of audit committees. Audit remuneration is further classified into audit fee and non-audit service fee.

Additionally, this study also recognized various explanatory factors in the literature (Zaman et al., 2011) may intervene in the audit process and have complex relations with audit fee and non-audit service fee. Following the study of Zaman et al. (2011), the researcher includes a number of control variables in the two main models of this study which are deemed important in determining audit quality. These control variables are further categorised into board effectiveness and company related factors. By incorporating the board effectiveness variables and company related factors variables into the two models of this study, the researcher can further examine as to whether the audit committee effectiveness has an influence on the audit fee and non-audit service fee. Finally, the outcome of this study is to find out whether an effective audit committee will undertake a more monitoring role which may improve the audit process and lower auditor remuneration.

Table 1.2 Functions of Audit Committee

S344A (5) of 1993 Listing Requirements of KLSE	S15.13 (1) of 2001 Listing Requirements of KLSE
(a) To review with auditor:	(1) To review with auditor and report to board of directors:
(i) The audit plan.	(a) The audit plan.
(ii) The audit committee's evaluation of the system of internal accounting controls.	(b) The audit committee's evaluation of the system of internal controls.
(iii) The audit committee's audit report.	(c) The audit committee's audit report.
(iv) The assistance given by the company's officers to the auditor.	(d) The assistance given by the employees of the listed company to external auditor.
(v) The scope and results of the internal audit procedures.	(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.
(vi) The financial statements of the company and the group.	(f) The internal audit programme, processes, the results of results of the internal audit programme, processes or investigation undertaken and whether or not appropriate action is taken on the recommendations of the internal audit function.
(vii) Any related party transactions that may arise within the company or group.	(g) The quarterly results and year-end financial statements, prior to the approval by the board of directors, focusing particularly on changes in or implementation of major accounting policy changes; significant and unusual events; and compliance with accounting standards and other legal requirements.
	(h) Any related party transaction and conflict of interest situation that may arise within the listed issuer or group including any transaction, procedure or course of conduct that raises questions of management integrity.
	(i) Any letter of resignation from the external auditors of the listed issuer.
	(j) Whether there is reason (supported by grounds) to believe that the listed issuer's external auditor is not suitable for re- appointment.
(b) To nominate a person or persons as auditor.	(2) To nominate a person or persons as auditor.

Source. Extract from Bursa Malaysia Resource Centre on August 24, 2015

Table 1.3 Prominent Past Scandals in Bursa Malaysia

	Name of Companies	Year	Offences
1	[a] Perwaja Steel Bhd	1988-1995	Misappropriation of funds, dubious contracts and dishonest accounting
2	[b]Aokam Perdana Bhd	1996-1997	Misappropriation of assets
3	[c]Repco Holdings Bhd	1997	Manipulation of share price
4	[d]Idris Hydraulic (M) Bhd	2001	Provide false statements
5	[b]Idris Hydraulic (M) Bhd	2003	Misappropriation of assets
6	[c]Hwa Tai Industries Bhd	2004	Unfair allocation of excess right shares
7	[c]Fountain View Development Bhd	2005	Share manipulation
8	[c]Transmile Group Berhad	2005-2006	Provide misleading statements
9	[c]Axis Incorporation Bhd	2006-2008	Provide false statements
10	[c]Megan Media Holdings Berhad	2006-2007	Provide false statements
11	[c]Linear Corp Bhd	2007	Misappropriation of assets
12	[e]Ekran Bhd	2009	Failure to disclose related party transactions
13	[c]Linear Corp Bhd	2009	Provide false statements
14	[f]Kenmark Industrial Co (M) Bhd	2010	Insider trading and market manipulation
15	[c]Silver Bird Group Bhd	2010-2011	Provide false statements

Source. (a) Kinibiz (2015), (b) Forest Monitor (2015), (c) Securities Commission Malaysia (2015), (d) Where is Ze Moola (July 28, 2011), (e) The Edge Markets (November 25, 2009), (f) The Edge Markets (June 4, 2010).