



**CORPORATE OWNERSHIP STRUCTURE AND  
AUDIT FEES: EVIDENCE FROM MALAYSIAN  
LISTED COMPANIES ON BURSA MALAYSIA**

**BY**

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## **ABSTRACT**

The increasing focus on the impact of different ownership structures is prompted by the existence of monitoring differences by shareholders on corporate affairs including the financial reporting process. The external auditors' reliance on the corporate internal control varies according to the different ownership structures with a concomitant variation in the fees charged to their clients. A number of corporate collapses worldwide have highlighted the need for strong corporate governance to strengthen the financial reporting process with an emphasis on audit quality. The purpose of this study is to investigate the association between corporate ownership structures and audit fees paid to external auditors by Malaysian companies listed on Bursa Malaysia. This study focuses on the extent of the auditor's reliance on the client's internal control inasmuch as the corporate ownership structures are varied, and, ultimately, affect the audit fees. This study applies the agency theory in formulating three hypotheses that guide the results analysis. By employing a multi regression model for a sample of 345 Malaysian companies listed on Bursa Malaysia, this study examines the relationship of ownership structure, namely, managerial ownership, foreign ownership and government ownership with audit fees using data for 2010. The results show a significant positive relationship between audit fees and firms with larger foreign ownership and government ownership but no significant relationship with firms with higher managerial ownership. This study contributes recent evidence concerning the relationship between corporate ownership structure and audit fees. The regulator may consider ownership structure on the standards or regulation setting in order to be practical and operationalized in line with the impact associated with different ownership structures. The practitioners may also design appropriate methodologies and procedures for the different ownership structures for high quality service and to standardize the risk mitigation process.

## ملخص البحث

تتم مطالبة زيادة التركيز على تأثير هياكل الملكية المختلفة من خلال وجود اختلافات رصد من قبل المساهمين على شؤون الشركات بما في ذلك عملية إعداد التقارير المالية. الاعتماد على المدققين الخارجيين "على سيطرة الشركات الداخلية تختلف وفقا لهياكل الملكية المختلفة مع اختلاف مصاحبة في الرسوم المفروضة لعملائها. وهناك عدد من الشركات في جميع أنحاء العالم ينهار سلطت الضوء على الحاجة إلى حوكمة الشركات قوية لتعزيز عملية إعداد التقارير المالية مع التركيز على جودة المراجعة. والغرض من هذه الدراسة هو استقصاء الارتباط بين هياكل ملكية الشركات وأتعاب التدقيق المدفوعة لمراجعي الحسابات الخارجيين من قبل شركات الماليزية المدرجة في بورصة ماليزيا. هذه الدراسة تركز على مدى الاعتماد على المراجع تحكم العميل الداخلي، بقدر ما هي متنوعة وهياكل الملكية للشركات، و، في نهاية المطاف، يؤثر على أتعاب التدقيق. هذه الدراسة تطبق نظرية الوكالة في صياغة ثلاث فرضيات التي توجه تحليل النتائج. من خلال استخدام نموذج الانحدار المتعدد لعينة من 345 من الشركات الماليزية المدرجة في بورصة ماليزيا، تبحث هذه الدراسة العلاقة بين هيكل الملكية، أي ملكية الإدارية، والملكية الأجنبية والملكية الحكومية مع أتعاب المراجعة باستخدام بيانات لعام 2010. أظهرت النتائج وجود علاقة طردية بين أتعاب المراجعة والشركات ذات الملكية الأجنبية وأكبر ملكية الحكومة ولكن لا توجد علاقة كبيرة مع شركات ذات الملكية الإدارية العليا. تساهم هذه الدراسة الأدلة الأخيرة بشأن العلاقة بين هيكل الملكية للشركات ورسوم مراجعة الحسابات. قد المنظم النظر هيكل الملكية على معايير إعداد أو تنظيم من أجل أن تكون عملية وتفعيل وفقا لتأثير المرتبطة هياكل الملكية المختلفة. قد الممارسين أيضا تصميم منهجيات وإجراءات ملائمة لهياكل الملكية المختلفة لخدمة ذات جودة عالية وتوحيد عملية تخفيف المخاطر.

## APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

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## DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Nurul Farha Binti Mohamed Rusdi

Signature.....

Date.....

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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MALAYSIA**

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## LIST OF ABBREVIATIONS

AC	Audit Committee
ACCA	Association of Chartered Certified Accountants
AFEE	Audit Fee
CG	Corporate Governance
EPF	Employees Provident Fund
FCCG	Financial Committee on Corporate Governance
FCF	Free Cash Flow
FOWN	Foreign Ownership
GAAP	Generally Accepted Accounting Principles
GOWN	Government Ownership
GLC	Government Linked Companies
GLIC	Government Linked Investment Companies
IASB	International Accounting Standard Board
IFRS	International Financial Reporting Standard
KLSE	Kuala Lumpur Stock Exchange
KWSP	Kumpulan Wang Simpanan Pekerja
LTAT	Lembaga Tabung Angkatan Tentera
LTH	Lembaga Tabung Haji
MCCG	Malaysian Code of Corporate Governance
MIA	Malaysian Institute of Accountants
MICPA	Malaysian Institute of Certified Public Accountants
MKD	Menteri kewangan Diperbankan
MOWN	Managerial Ownership
PNB	Permodalan Nasional Berhad
RPG7	Recommended Practise Guide 7
SEC	Securities and Exchange Commission

# **CHAPTER ONE**

## **INTRODUCTION**

### **1.0 INTRODUCTION**

This chapter serves as an introductory chapter for the study. It begins with the background of the study, followed by the research problem, objective and motivation of the study. The following section discusses the significance of the study and the chapter concludes with a presentation of the organization of the study.

### **1.1 BACKGROUND OF THE CASE**

A number of corporate collapses that occurred around the world highlighted the need for strong corporate governance as a monitoring mechanism. Among the identified issues are the need for the improvement of the role of shareholders, protection of minority shareholders, the need for investors' confidence, transparency in directors' dealing, and an emphasis on the fiduciary duties of directors (Abdul Wahab, Zain and James, 2011b; Mustapha and Ahmad, 2011). As a result, a Finance Committee on Corporate Governance formed the Malaysian Code on Corporate Governance (MCCG) in 2000 as the basis for the Bursa Malaysia Listing Requirements (LR) and has strengthened efforts towards enhancing corporate governance practice in Malaysia. The MCCG sets out broad principles and specific recommendations on structures and processes that companies should adopt in making good corporate governance as an integral part of their business dealings and culture. The MCCG 2012 was made effective on 31 December 2012, which means that listed companies with financial year ending 31 December 2012 onwards will be required to report on MCCG

2012 and disclosure should be made in the annual report published in 2013. The Securities Commission (SC) also encourages companies to make an early transition to the principles and recommendations elaborated upon in this new code on corporate governance. The MCCG 2012 is arranged as follows: (MCCG, 2012, p.5)

- (1) Eight main principles – which are clarifying the role and responsibilities of the board in providing leadership, enhancing board effectiveness through strengthening its composition and reinforcing its independence, fostering commitment of the board, upholding integrity in financial reporting, recognizing and managing the risk, ensuring timely and high quality disclosure, and strengthening the relationship between company and shareholders.
- (2) Recommendation – a standard that the companies are expected to adopt as part of their governance structure and processes. Listed companies should explain in their annual reports how they have complied with the recommendations. Although companies are allowed to determine the best approach to adopt the principles, they should explain the reasons.
- (3) Commentaries – each recommendation is followed by a commentary that seeks to assist the companies in understanding the recommendation. It also provides some guidance in implementing the recommendation.

In Malaysia, every company that is incorporated under the Company Act 1965 is required to have its financial statements audited annually. Whereas auditing in Malaysia is overseen by the Malaysian Institute of Accountant (MIA) and must be in compliance with the auditing standards that are effective in Malaysia, namely, the International Standard of Auditing. MIA is a statutory body established under the Accountant Act 1967 to regulate and develop the accountancy profession in Malaysia.

In Malaysia, auditors' reports are signed by licensed accountants who are registered with and administered by the MIA. The MIA implements professional standards and practices among accountants in Malaysia based on internationally accepted guidelines as standards and By-Laws for its members to comply with in maintaining the integrity of the profession. In 2010, the MIA issued a Recommended Practice Guide 7 (Revised) (RPG7) on the charging of audit fees. This replaced the earlier practice guide issued in 2007. RPG7 represents the best current practice guide as issued by the MIA and came into effect on 1 March 2010. The professional accountants that are in public practice are encouraged to apply this RPG7 in the performance of and in charging fees for their respective duties.

In Malaysia, the By-Laws (On Professional Conduct and Ethics) (2010)<sup>1</sup> and Recommended Practice Guide 7 (RPG7) issued by the MIA stipulate a recommended basis for determining the audit fees. The guidelines emphasize that the level of fee mutually agreed between the auditor and the client largely depends upon four factors: (a) the skill and knowledge required, (b) level of training and experience of the staff involved, (c) the time necessarily occupied and the degree of responsibility, and (d) the urgency of the work involved.<sup>2</sup> Based on the four factors for determining the audit fee according to RPG7, the audit firm is not forced to strictly follow the list of audit fees recommended in RPG7 as the RPG7 rules are likely open for further interpretation and negotiation between the auditors and their clients. Audit firms may charge different levels of fees to their clients depending on the client's condition and control mechanism. This means that audit fees that are paid to external auditors vary

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<sup>1</sup> The Revised By-Laws (On Professional Ethics, Conduct and Practice) of the Malaysian Institute of Accountants are issued by the Council of the Malaysian Institute of Accountants and came into effect on 1 January 2011.

<sup>2</sup> See By-Laws (On Professional Ethics, Conduct and Practice) Section 240.2A and RPG7 Para 2.10

among Malaysian companies depending on the situation and control mechanism of the companies that are being audited.

Furthermore, some prior literature shows that audit fees that are paid to external auditors varied according to the ownership structure of the firms (Mitra, Hossain and Deis, 2007; Khan, Hossain and Siddiqui, 2011; Adelopo, Jallow and Scott, 2012). This is because the different ownership structures may give rise to different methodologies or mechanisms being used by the shareholders in monitoring the day-to-day business affairs of the firms including the financial reporting process. The reliance of external auditors on the corporate internal control varies among the different ownership structures, and, hence, they employ different levels of audit work and effort. Consequently, this affects the level of audit fees charged to their clients. Thus, this study attempts to examine the impact of corporate ownership structures that might influence the level of audit fees paid to the external auditors.

## **1.2 RESEARCH PROBLEM**

A number of corporate scandals worldwide, such as Enron, Arthur Anderson, Worldcom, and Port Klang Free Zone (PKFZ), have affected the reputation of the accounting profession and also financial reporting (Griffin, Lont and Sun, 2009). These accounting scandals have highlighted the need for strong corporate governance to strengthen the financial reporting as well as to emphasize the audit quality. The inefficient and malfunctioning corporate governance mechanisms are believed to be among the major factors responsible for these scandals (Mustapha and Ahmad, 2011; Abdul Wahab, Zain and James, 2011a). Accordingly, various internal and external monitoring mechanisms have been suggested in order to resolve and mitigate such issues. The auditors are considered to be part of the corporate monitoring mechanism



whereby they represent the shareholders in auditing and examining the day-to-day activities of the firm's management. In this case, the shareholders will rely on the auditors to act as a monitoring mechanism on their behalf.

In a developing capital market, such as Malaysia, institutional differences exist. Prior studies highlighted that the differences include a weak market for corporate control, more concentrated stock ownership and significant government ownership in the listed firms. The unique corporate ownership environment in Malaysia, especially with regards to the Malaysian listed companies, potentially provides evidence of the existence of monitoring differences by the shareholders on the corporate affairs, including the financial reporting process (Yatim, Kent and Clarkson, 2006; Mitra et al., 2007). As a result of the unique corporate ownership environment, the work of auditors has received attention by the users of financial statements, especially shareholders in order to ensure and preserve the reliability and credibility of the financial statements. In addition to this situation, this unique corporate ownership environment may be a motive for further research in examining the relationship between corporate ownership structures and audit fees in the Malaysian business environment. It is believed that corporate ownership structures of the companies can affect the level of audit fees paid to external auditors.

In addition, research that focuses directly on the type of corporate ownership structure and audit fees are still at the infant stage, especially in Malaysia. Most of the studies in Malaysia did not consider ownership structures as their variable of interest, such as Abdul Wahab et al. (2011a), who examined the relationship between political connection, corporate governance and audit fees. The study uses the ownership variable as the control variable.

Most of the prior studies on corporate ownership type and audit fees employ data before 2007, when the implementation of the MCCG in Malaysia was in its early stages. However, this study uses the most updated data available, which are for 2010, to see whether a new trend occurs and to ascertain whether there is any variation in the results compared to prior studies.

### **1.3 OBJECTIVES OF THE STUDY**

The main objective of this study is to investigate the impact of different types of corporate ownership structure and audit fee among Malaysian companies listed on Bursa Malaysia. Given that the Bursa Malaysia requirements require listed companies to disclose MCCG practices in their corporate annual report; this provides an avenue for a viable research related to corporate governance effectiveness. The presence of corporate governance characteristics could improve the quality of financial reporting and ensure proper monitoring control of the company. The results of this research are expected to enhance the financial reporting quality by improving the monitoring control of the company (by different types of ownership structure) as recommended by MCCG Malaysia. External auditors are part of the corporate governance mechanism to ensure proper monitoring control of the company. As for this study the corporate ownership structures are selected as the dependent variable as one of the corporate governance mechanisms to be examined in respect of their relationship with audit fees. It is also documented that audit fees paid to external auditors are part of monitoring cost for the company, which is also known as agency cost.

Furthermore, this study also attempts to fill the gap as highlighted by Yatim et al. (2006) who suggested that in order to provide better insight into the findings in future research on audit fees, we have to consider the ownership structure variables as

one of the corporate governance mechanisms to be tested with audit fees. Apart from that, there is limited literature on audit fees and corporate governance that utilises the corporate ownership structure as a basis to further investigate the determinants of audit fees, especially in Malaysia, for instance, Neimi, (2005) in Finland, Mitra et al. (2007) in the US, Ghosh (2011) in India, Khan et al. (2011) in Bangladesh and Adelopo in the UK. These researchers argue that different monitoring controls in different ownership structures will lead the investors to trust the auditors to monitor the management of the company and provide reliable information for decision making. This level of trust and delegation to auditors differs according to the different types of corporate ownership structure. Therefore, this study investigates the impact of corporate ownership structure on the level of audit fees as representation of the agency cost incurred resulting from different types of shareholders by using data from Malaysian listed companies.

Therefore, this study aims to examine the relationship of the different types of ownership structure, such as managerial ownership, foreign ownership and government ownership with the level of audit fees paid to external auditors. Based on the research objective, this study was undertaken to provide answers to the research question:

RQ:           What is the impact of corporate ownership structure on the level of audit fee in the Malaysian companies listed on Bursa Malaysia?

#### **1.4 MOTIVATION FOR THE STUDY**

There is limited research that examines the impact of corporate ownership structure, as one of the corporate governance mechanisms, on audit fees. This situation has motivated the current study to conduct further research on the impact of the corporate

ownership structure on audit fees in the context of the Malaysian environment, which is a developing country. Most prior studies were conducted among the developed countries, such as by Neimi, (2005) in Finland, Mitra et al. (2007) in the US, and Adelopo et al. (2012) in the UK. There is a Malaysian study by Abdul Wahab et al. (2011a), which examined the relationship between political connections, corporate governance and audit fees in Malaysia. However, the paper only used institutional ownership and managerial ownership variables as control variables, and did not consider ownership structure as their variable of interest. Thus, this study attempts to investigate if there are any relationships between corporate ownership structure and audit fees paid to external auditors by using the most recent available data, that is, data from 2010 from Malaysian companies listed on Bursa Malaysia.

This study is also motivated by the changes in corporate governance in Malaysia, especially after the introduction of the Malaysian Code on Corporate Governance (MCCG) in 2007. This MCCG 2007 supersedes the 2000 Code. The Securities Commission has taken a progressive effort in promoting and sustaining a strong culture of corporate governance. The changes in corporate governance might affect the ownership structure among Malaysian companies. Thus, a study using the latest available data, that is for 2010, on the impact of the ownership structure on the audit fees, may be interesting, especially with regards to the Malaysian listed companies, which are in a unique corporate ownership environment.

This study extends previous studies on the relationship between corporate governance and audit fees by Yatim et al. (2006). Their study, which is in the context of Malaysian business environment, suggested that the differences in corporate ownership structure might be a better platform to explain the impact of corporate governance structure and audit fees paid to external auditors.

## **1.5 SIGNIFICANCE OF THE STUDY**

This study focuses on the ongoing issue in auditing on the variation of fees charged by the auditors in the current audit market. It investigates the association between corporate ownership structure and audit fees paid to the external auditors. Three ownership structures will be tested, namely, managerial ownership, foreign ownership and government ownership to determine their relationship with the audit fees among Malaysian listed companies. This study contributes to the existing literature on corporate ownership structure and audit fees, utilising recent data in Malaysia as one of the emerging economies and it also contributes by examining the ownership structure as a variable of interest, instead of as a control variable as most prior studies.

This study hopes that it may also be beneficial to Malaysian companies to improve their corporate governance system if the result of this study shows that the variation in audit fees paid to external auditors is significantly determined by the different types of corporate ownership structure. This study may contribute by investigating whether there is any difference in the internal control mechanism among different ownership structures. It also hopes that as a result of this study's findings, the regulators may consider different types of ownership structure in the standards setting, for example, accounting standards and code on corporate governance in order to be practical and operationalized in line with the impact from the different types of ownership structure.

The purpose of this study is to investigate the relationship of corporate ownership structure, such as managerial ownership, foreign ownership and government ownership with audit fees paid to external auditors. This study focuses on to what extent the auditors' work, effort and resources may be affected by the different types of ownership structure among their clients. Thus, this study expects to

make some contribution not only to the auditing profession (i.e. auditor) but also to the regulators and top management of companies.

## **1.6 ORGANISATION OF THE STUDY**

The structure of the thesis is as follows:

Chapter 1: **Introduction.** The introduction elaborates upon the background, objectives of the study, motivations of the study, and the significance of the study.

Chapter 2: **Literature Review.** This chapter will include some of the prior literature that has been done in prior studies concerning the determinant of audit fees, issues regarding ownership structure and audit fees, corporate governance and reputation of audit firm. At the end of the literature review process, this chapter will identify some of the gaps that have not been addressed by prior studies.

Chapter 3: **Theory and Hypotheses Development.** This chapter explains the general agency theory and its relation to this study. This chapter will also include the theoretical framework concerning how the hypotheses are being developed; the assumptions from prior studies will also be included in this chapter in order to support the development of the hypotheses. This chapter will also discuss the expected relationship of all independent variables (managerial ownership, foreign ownership and government ownership) and control variables (client leverage, client complexity, client risk and client profitability) on audit fees.

Chapter 4: **Research Methodology.** This chapter covers the research design, data collection method and data analysis. This chapter will discuss in detail

how the hypotheses will be tested. The sample selection process will also be thoroughly discussed in this chapter.

Chapter 5: **Analysis of Results and Discussions.** In this chapter, the findings will be analysed and interpreted and will be compared with the findings found in prior studies.

Chapter 6: **Conclusions.** This chapter will conclude the whole thesis and outline some of the limitations of the study. Besides concluding and providing the limitations of the study, this chapter will also provide some suggestions for future research in addressing the limitations faced during the study.

## **1.7 CONCLUSION**

The study extends the literature on corporate governance and audit fees by using different types of corporate ownership structure as a proxy for the corporate governance mechanism and tests using a sample from companies listed on Bursa Malaysia. The objective of this study is to investigate the relationship of corporate ownership structure, such as managerial ownership, foreign ownership and government ownership with audit fees paid to external auditors.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.0 INTRODUCTION**

This chapter provides an overview of corporate governance, ownership structure and audit fees based on prior research. This chapter is organized for the purpose of determining the gaps that may exist between the studies that have been done previously. These gaps have guided the author to identify the research problems and develop the research objective as was discussed in the previous chapter.

The first section discusses the overview of audit fees and the literature on the determinants of audit fees. The next section of the chapter will discuss the literature with respect to corporate governance, corporate ownership structure and audit fees. This is followed by the research gaps and ends with the conclusion of the whole discussion in this chapter.

#### **2.1 AUDIT FEES: AN OVERVIEW**

Audit fees comprise all the fees that are charged by the auditors to their clients either statutory audit fees and non-audit fees and include costs that are incurred by the auditors in rendering their professional audit services to their clients in statutory audit of the clients' financial statements or non-statutory audit, which are also known as non-audit services, such as due diligence work, special audit, withholding tax verification and so on (Hoitash, Markelevish and Barragato, 2007; John, Hussain, Carl, Sanusi and Sulong, 2012). The Malaysian Institute of Accountants issued RPG 7 (2010), which is related to the recommended methodologies and level of audit fees