THE IMPACT OF GOVERNANCE MECHANISMS ON AUDIT FEES AND NON-AUDIT FEES IN ISLAMIC BANKS IN MALAYSIA

BY

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A dissertation submitted in fulfilment of the requirement for the degree of Master of Science (Accounting)

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JUNE 2019

ABSTRACT

This study aims to examine whether corporate governance mechanisms affect the audit process in terms of audit fee pricing and also non-audit fee for regulated companies. The governance mechanisms are the characteristics of board of directors (size and independence), the characteristics of audit committee (size, expertise, independence and meetings) and the characteristics of *Shariah* committee (size and expertise). The study first reviews prior literature and identifies factors within the categories of client size, audit risk and corporate governance mechanisms that are likely to influence audit fees and non-audit fees of Islamic banks. It then regresses these variables on audit fees and non-audit fees using panel data regression model for a sample of Islamic banks in Malaysia. From 112 observations of the study sample, this study finds that audit committee independence and *Shariah* committee expertise have significant association with audit fees. It also finds that audit committee size, audit committee independence and audit committee meetings have significant association with non-audit fees. However, most corporate governance variables lack significant relationships with audit fees. It shows that internal governance agents in a regulated industry do not demand a more extensive audit. It could be because of the overlap between regulatory oversight and audit monitoring. This study also provides support for the step up practice recommended in MCCG 2017 regarding the importance of establishing audit committee that consists of solely independent directors that could not only guarantee proper monitoring function but also reduce control risk and subsequently will be charged with lower audit fees by the external auditors. It also suggested that the *Shariah* committee with accounting qualification/background could not only ensure the *Shariah* compliance of Islamic banking and finance business but also decrease the external audit fees. Apart from contributing to the literature on corporate reporting and governance system, this study provides feedback to the regulatory bodies on governance practices in Islamic banking institutions in Malaysia.

مُلخَّص البحث

يهدف هذه البحث إلى دراسة ما إذا كانت آليات إدارة الشركات تؤثر في عملية تدقيق الحسابات من حيث تسعير رسوم تدقيق الحسابات، والرسوم غير المتعلقة بتدقيق الحسابات للشركات المنظمة، وتُعرف الآليات الإدارية على أنها من: اختصاص مجلس الادارة (من حيث الحجم والاستقلالية)، واختصاص لجنة التدقيق (من حيث الحجم والخبرة والاستقلالية والاجتماعات)، واختصاص اللجنة الشرعية (من حيث الحجم والخبرة)، ويقوم البحث أولاً على استعراض الدراسات السابقة؛ لتحديد العوامل التي يرجح أن تؤثر في رسوم تدقيق الحسابات والرسوم غير المتعلقة بتدقيق الحسابات للمصارف الإسلامية، من مثل: الملاءة المالية للعميل، ومخاطر تدقيق الحسابات، وآليات إدارة الشركات، ثم يُطبق البحث أنموذج معادلة الانحدار باستخدام البيانات اللوحية لعينة من المصارف الإسلامية الماليزية مؤلفة من 112 مُشاهدة، وقد بان للبحث أن استقلالية لجنة التدقيق وخبرة اللجنة الشرعية ترتبطان ارتباطًا معنويًّا برسوم تدقيق الحسابات، وأن حجم لجنة تدقيق الحسابات واستقلاليتها واجتماعاتها ترتبط ارتباطًا معنويًّا بالرسوم غير المتعلقة بتدقيق الحسابات؛ غير أن معظم المتغيرات الأخرى لإدارة الشركات لم تُظهر علاقات مهمة مع رسوم تدقيق الحسابات، ويُبين البحث أن وكلاء الإدارة الداخلية في الصناعات المنظمة لا يطالبون بإجراء تدقيق أشمل للحسابات، ويمكن أن يكون ذلك بسبب التداخل بين الرقابة التنظيمية والرقابة على تدقيق الحسابات، ويوفر البحث أيضًا دليلاً داعمًا لعملية الانتقال التدريجي التي أوصى بها القانون الماليزي لإدارة الشركات لعام 2017، ويتعلق بأهمية إنشاء لجنة لتدقيق الحسابات تتألف من المديرين المستقلين فقط؛ ممن يمكنهم ضمان الرقابة السليمة وتقليل مخاطر السيطرة؛ مما يؤدي فيما بعدُ إلى فرض رسوم تدقيق حسابات أقل مما يفرضه مُدققو الحسابات الخارجيون، ويُشير البحث أيضاً إلى أن اللجنة الشرعية ذات المؤهلات المحاسبية؛ يمكنها ضمان امتثال الأعمال المصرفية الإسلامية للشريعة، وتخفيض رسوم التدقيق الخارجي للحسابات، فضلاً عما سبق؛ يُسهم البحث في الدراسات المتعلقة بالإبلاغ المؤسّسي ونُظُم الإدارة، ويُقدم مراجعة للهيئات الرقابية في الممارسات الإدارية في المؤسسات المصرفية الإسلامية في ماليزيا.

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 (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.

Vicky Vendy

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ACKNOWLEDGEMENTS

First of all, thanks to Almighty Allah S.W.T. for graciously bestowing me the perseverance to undertake this research. I sincerely thank all those who have supported and helped me in writing this dissertation. A special thanks and deepest appreciation to my supervisors, Dr. Maslina Ahmad and Assoc. Prof. Dr. Hairul Azlan Annuar who have provided guidance and advice throughout the completion of the dissertation.

Secondly, many thanks go to the Indonesia Endowment Fund for Education (LPDP), Ministry of Finance, the Republic of Indonesia Ministry for their financial support and assistance throughout the process of study and dissertation completion.

Lastly, many thanks to my parents and my brothers and sisters for their patience and moral support, postgraduate colleagues and staff in International Islamic University Malaysia (IIUM) for the support and encouragement throughout my studies.

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LIST OF ABBREVIATIONS

AF	Audit Fees
AFB	Asian Finance Bank
ARL	Audit Report Lag
BCBS	Basel Committee on Banking Supervision
BIMB	Bank Islam Malaysia Berhad
BIS	Bank for International Settlements
BNM	Bank Negara Malaysia
CA	Chartered Accountant
CIBAFI	Council for Islamic Banks and Financial Institutions
CPA	Certified Public Accountant
CPD	Continuous Professional Development
GLC	Government-Linked Companies
GP1-i	Guidelines on Corporate Governance for Licensed Islamic Banks
IFIs	Islamic Financial Institutions
IFSA	Islamic Financial Service Act
IFSB	Islamic Financial Services Board
LM	Lagrangian Multiplier
MBSB	Malaysia Building Society Berhad
MCCG	Malaysian Code on Corporate Governance
MIA	Malaysian Institute of Accountants
MICPA	Malaysian Institute of Certified Public Accountant
NAF	Non-Audit Fees
NGLC	Non-Government-Linked Companies
NPL	Non-Performing Loans
OECD	Organisation for Economic Cooperation and Development
SGF	*Shariah* Governance Framework
VIF	Variance Inflation Factor

CHAPTER ONE

INTRODUCTION

1.1 INTRODUCTION

This chapter consists of explanation relating to the background of the study, the problem statement, the objective of the study, research questions, the motivation of the study, the significance of the study and the scope of the study. Finally, it ends with the explanation of the structure of the study.

1.2 THE BACKGROUND OF THE STUDY

Auditing has a pivotal role to guarantee the quality of financial reports. DeAngelo (1981) explained the definition of audit quality as the likelihood of auditor to find out and report errors in the accounting system. An audit assures that the company's financial statements are presented fairly based on the performance of the company. As a monitoring tool, financial audits will give benefit to shareholders and creditors (Kasim, Hashim, & Salman, 2015).

Many factors that could contribute to the auditors' credibility in conducting audit work, one of them could be corporate governance structure. Nevertheless, some problems of financial reporting process may have their origins in deficiencies of the system of corporate governance (Whittington, 1993). The joint research of General Council for Islamic Banks and Financial Institutions (CIBAFI) and World Bank Group (2017) argued that the lack of good corporate governance was among the causes that played a role to the global financial catastrophe of 2007–2008.

Consequently, global standard setters such as the Organisation for Economic Co-operation and Development (OECD) and the Basel Committee on Banking Supervision (BCBS) attempted to revise and strengthen their guidelines on good corporate governance practices. Good corporate governance strengthens financial institutions and also plays an important role to create resilient economies and economic growth (CIBAFI and World Bank, 2017). Therefore, a suitable corporate governance structure will improve the financial reporting quality, thus increasing the credibility of auditors in performing their duties to detect and report misstatements.

Bank Negara Malaysia (BNM) has issued Guidelines on Corporate Governance for Licensed Islamic Banks (GP1-i) as guidelines to establish good corporate governance which are aimed to enhance the quality of financial reporting and auditing. The guidelines expect that the effective boards and audit committees can safeguard the independence of auditor by carrying out the duty to select auditor, formulate the auditor's remuneration and give an independent platform for auditor to express their professional opinions on the policies of management. Therefore, such corporate governance amendment will not only impact the quality of audit but also on the remuneration of auditor, i.e., audit fees and non-audit fees (Zaman, Hudaib, & Haniffa, 2011).

Drawing upon the recommendations in the GP1-i (Bank Negara Malaysia, 2011a), it is argued that for the board of directors to be effective, the number of directors should be proportional with the size, operations and complexity of the Islamic bank. The composition of the board shall consist of a majority of independent directors and the positions of CEO and board chairman also should not be occupied by one person at the same time. While for the effectiveness of the audit committee, the audit committee must consist of non-executive directors only with no less than three members, of which the majority should be independent directors. At least one member should possess accounting expertise or experience in the field of finance.

Due to the implementation of *Shariah* Governance Framework (SGF) in 2011, this study also includes the *Shariah* committee characteristics as the independent variables. Drawing upon the recommendations in the SGF (Bank Negara Malaysia, 2011b), for effective *Shariah* committee, the composition of *Shariah* committee must not be less than five members and they are required to possess adequate knowledge and know-how on finance in general, and Islamic finance in particular.

Therefore, in this study, the attributes of board of directors (size and independence), the attributes of audit committee (size, expertise, independence and meetings) and the attributes of *Shariah* committee (size and expertise) are used as explanatory variables to test their association with the extent of audit fees and non-audit fees. Besides that, firm-level characteristics that could influence the extent of audit fees such as client size and audit risk are analysed as well.

The significant growth of Islamic banks in Malaysia also has amplified the motivation in conducting this study by focusing on how corporate governance mechanisms impact the audit fees and non-audit fees of such Islamic banks. Thus, this study will investigate the association between corporate governance mechanisms, audit fees and non-audit fees among Islamic banks in Malaysia.

1.3 THE PROBLEM STATEMENT

Some accounting scandals worldwide have tarnished the audit profession and also financial reporting. The failure of Enron, Worldcom, Arthur Andersen, Lehman Brothers and Port Klang Free Zone indicated the dire need for effective corporate governance to tackle those scandals and return the confidence of the audit profession.

In the case of the bankruptcy of giant investment bank in the US, Lehman Brothers, the failure of oversight threatened the wealth of shareholders, the jobs of their employees and the pensions of their retired workers (Nordberg, 2011). It still could occur despite the widespread use of corporate governance ranging from board of directors, audit committee, auditors, credit rating agencies and voluntary codes of conduct. Therefore, the malfunction of corporate governance practices is strongly believed to contribute to catastrophic accounting scandals.

These scandals have incited distrust to the audit profession and weakened investor confidence in corporate financial reports. Further, the financial crisis that occurred in 2008 also harmed investor confidence in auditor credibility and company's financial reports. This financial crisis and corporate scandals have urged regulators and companies to amend the practices of corporate governance (Yasin & Nelson, 2012).

In many countries, including Malaysia, corporate scandals stimulated the amendment of corporate governance guidelines (Bhatt, 2016). The guidelines were to prevent the occurrence of such scandals in the future and to improve and supervise corporate governance practices. As a result, improvement for various internal and external monitoring mechanisms emerge to reinforce the quality of corporate governance. Auditors are considered as part of the external mechanisms that act on behalf of shareholders to inspect financial report and investigate irregularities, errors and misstatement contained in it.

The separation of ownership and control can create a conflict between managers who may take part in activities for the sake of personal interests and shareholders who have limited ability to monitor the management decisions closely. To control and monitor manager's decisions, shareholders are likely to pay monitoring costs such as the costs to prepare and audit the financial reports (Naser & Hassan, 2016). The quality of audit services being provided will determine the effectiveness of external audit in strengthening the credibility of financial reports. In this context, the audit fee can be a proxy of audit quality (DeAngelo, 1981; Naser & Hassan, 2016).

As the leading country in the Islamic banking and finance industry, Malaysia introduced not only Guidelines on Corporate Governance for Licensed Islamic Banks (GP1-i) in 2011, but also *Shariah* Governance Framework (SGF) to establish credible *Shariah* governance structure in 2011. Later, it also issued Islamic Financial Service Act (IFSA) in 2013 to harmonise all regulations in the Islamic financial sector.

The improved form of governance in Malaysia should enable more comprehensive monitoring of Islamic banks in Malaysia. Therefore, it needs to know whether the more comprehensive monitoring will also require more extensive audit to enhance audit quality, which subsequently increases audit fees (demand-based perspective). On the contrary, there is also a possibility that the more comprehensive monitoring will enhance the strength of internal control, boost the credibility of the financial report and make auditors reduce their audit effort, which will result in the decrease of audit fees (risk-based perspective).

Those two conflicting views, demand-based perspective and risk-based perspective, persist on audit fees research. Prior studies also reported mixed results related to the relationship between corporate governance mechanisms and audit fees either on financial or non-financial companies. The demand-based perspective suggests that high-quality corporate governance mechanisms require better quality of audit. More diligent, expert and independent board and audit committee likely require additional audit work performed to safeguard their reputation capital and avert the costly litigation risk (Carcello, Hermanson, Neal, & Riley, 2002; Zaman et al., 2011).

They may require a lower materiality level, which results in increased substantive testing and audit fees (Goddard & Masters, 2000). Some research proved this evidence and supported the demand-based perspective (Adelopo, Jallow, & Scott, 2012; Carcello et al., 2002; Lifschutz, Jacobi, & Feldshtein, 2010; Naser & Hassan, 2016; Wahab, Zain, & James, 2011b; Yasin & Nelson, 2012; Yatim, Kent, & Clarkson, 2006; Zaman et al., 2011).

On the other hand, some studies observe a negative association between corporate governance mechanisms and audit fees (Boo & Sharma, 2008; Bortolon et al., 2013). It shows that auditors decrease their audit hours and consequently audit fees in the presence of good governance mechanisms because they notice that such governance can decrease control and financial reporting risks (Boo & Sharma, 2008). One task of the audit committee is to assess the adequacy of internal controls, leading to more effective systems. Therefore, a more enhanced level of internal controls should reduce audit hours and consequently, decrease audit fee paid to external auditor (Goddard & Masters, 2000).

Under the risk-based point of view, auditors deliberately modify the audit procedures based on the identified client risks. The identification of a client with higher risks would intensify the audit effort and cause more expensive audit fees. On the contrary, auditors may cut down audit fees when they notice lower client risks. When board of directors and audit committee are strong and independent, auditors would have greater assurance that internal controls and compliance processes are functioning well, and financial reports are less likely to include material misstatements, omissions and frauds. In this case, the auditors could slash audit hours and consequently, decrease audit fee (Boo & Sharma, 2008; Bortolon et al., 2013).

The opposite side will come if auditors perceive the board of directors and audit committee are weak and less independent.

However, not only audit fees will be impacted by the corporate governance mechanisms, but it is also non-audit services. At the same time, an audit firm may also provide consultancy services to assist its clients in preparing the financial reports according to the accounting, taxation and governance regulation (Rashid, Lokman, Annuar, & Hamdan, 2018). These services would possibly lead toward another fee charged by audit firm.

There will be a motivation for audit firm that is hired to act as both auditor and consultant to hide consulting deficiencies detected during the audit to maintain the reputation of its consulting service. It threatens the auditor's independence. Generally, a threat to auditor's independence can be defined as any situation which raises the likelihood that an auditor will not truthfully reveal the results of the audit investigation (Bortolon et al., 2013; Hamid & Abdullah, 2012; Simunic, 1984).

On the other hand, there may be efficiencies related to dual services provided by audit firm. For instance, non-audit services that can be bought from the auditor could reduce company's search costs for a skilled and experienced consultant. Additionally, since each service necessitates know-how about a company's operations and its industry, there may also be a knowledge externality related to the provision of one or both services. Both views about non-audit services indicate that the issue can be simplified to a cost/benefit trade-off: certain non-audit services may pose a threat to auditor independence, but, most of the time, dual services provided by audit firm are likely to be more efficient (Simunic, 1984).

Regarding non-audit fees, the research also found inconclusive results. Some studies reported positive association between governance mechanisms and non-audit fees (Hamid & Abdullah, 2012; Zaman et al., 2011). On the contrary, Bortolon et al. (2013) reported negative association between governance mechanisms and non-audit fees. Therefore, the importance of audit fees and non-audit fees have motivated this study to investigate influential factors such as corporate governance mechanisms.

Furthermore, previous studies on audit fees have mostly eliminated financial institutions from their samples due to their complexities and uniqueness (Boo & Sharma, 2008). The study related to the impact of corporate governance variables on audit fees and non-audit fees in financial institutions is mostly unknown. It is still not obvious on how corporate governance could influence the audit process regarding audit pricing in the highly-regulated banking industry since the existence of regulatory supervision could either decrease or increase the necessity for internal monitoring by corporate governance mechanisms (Boo & Sharma, 2008).

This study adds to Boo and Sharma (2008) by investigating not only audit fees but also non-audit fees and their relationship with firm-level characteristics and corporate governance mechanisms such as board of directors, audit committee and *Shariah* committee. While the empirical results provide evidence that governance mechanisms are negatively associated with audit fees in a study using conventional banks (Boo & Sharma, 2008), to our knowledge, there is no study on audit fees and non-audit fees using Islamic banks as the sample. Therefore, this study attempts to address the research gap by investigating the association between corporate governance mechanisms, audit fees and non-audit fees using a sample of Islamic banks, especially in Malaysia.

1.4 THE OBJECTIVE OF THE STUDY

The primary objective of this study is to empirically investigate the possible relationship between the governance mechanisms with the amount of audit fees and non-audit fees paid to external auditors of Islamic banks in Malaysia. In this study, corporate governance mechanisms refer to board size, board independence, audit committee size, audit committee independence, audit committee expertise, audit committee meeting, *Shariah* committee size and *Shariah* committee expertise.

Particularly, the purposes of this study are stated as follows:

1. To examine the extent of audit fees, non-audit fees and corporate governance mechanisms in the Islamic banks in Malaysia.
2. To examine the association between audit fees, non-audit fees and the corporate governance mechanisms in the Islamic banks in Malaysia.

By analysing the annual reports of Islamic banks in Malaysia from 2011 to 2017, this study was conducted to answer the research question;

RQ1: To what extent do audit fees, non-audit fees and the corporate governance mechanisms exist in the Islamic banks in Malaysia?

RQ2: Is there any association between audit fees, non-audit fees and the corporate governance mechanisms in the Islamic banks in Malaysia?

1.5 THE MOTIVATION OF THE STUDY

There are only limited studies that examine the influence of governance mechanisms on audit fees using the sample of financial institutions. Most of them excluded financial institutions from their sample. To our knowledge, Fields, Fraser and Wilkins (2004) and Boo and Sharma (2008) are the only studies that investigated the determinants of audit fees using financial institutions as their sample.

The study of Fields et al. (2004) is one of the influential studies on audit fees using the sample of the banking industry, but it only used firm-level characteristics as the explanatory variables. Then, Boo and Sharma (2008) used the corporate governance mechanisms, in addition to firm-level characteristics as the explanatory variables. Therefore, due to the enormous growth of Islamic banks in Malaysia, it has encouraged the current study to conduct further research on the impact of governance mechanisms on audit fees and non-audit fees using a sample from Islamic banks in Malaysia.

The improvement of the regulatory environment and its current requirements consequently will give changes to the governance of Islamic banks and provide an opportunity to conduct further study in this area. This study uses data taken from annual reports from 2011 to 2017. Due to the implementation of SGF that should take effect starting 1 January 2011 which encouraged Islamic banks to disclose the data related to *Shariah* committee, this study chooses 2011 as the initial year because of the completeness of the data. The year 2017 is the latest data that is available on Islamic banks' websites.

1.6 THE SIGNIFICANCE OF THE STUDY

This study has some important reasons. First, it contributes to expanding limited existing prior literature about corporate governance, audit fees and non-audit fees using Islamic banks. This study extends the previous study (Boo & Sharma, 2008) by selecting Islamic banks as the sample. To our knowledge, no prior attempt had been made to examine the association between corporate governance mechanisms and audit fees and non-audit fees using Islamic banks in Malaysia since SGF became effective starting 1 January 2011. So, this study will address the research gap by explaining whether effective corporate governance mechanisms in Islamic banks will increase or decrease audit fees and non-audit fees.

Second, this study adds to the stream of research on audit fees, non-audit fees and corporate governance, by revealing whether *Shariah* committee characteristics such as *Shariah* committee size and *Shariah* committee expertise are important determinants of audit fees and non-audit fees. So, this study extends the audit fees, non-audit fees and corporate governance literature by including not only board and audit committee, but also *Shariah* committee, which is a unique characteristic in the Islamic banking industry.

Third, this study expects to examine the effect of several governance reforms such as GP1-i 2011, SGF 2011 and IFSA 2013 and Malaysian Code on Corporate Governance (MCCG) 2017 on both audit fees and non-audit fees. This study is not only an academic pursuit, but it could be relevant to policymakers in the Islamic banking industry in Malaysia who continually find a way to improve the quality of corporate governance and enhance the enforcement of governance code in the Islamic banking industry. By carrying out a study on the association of corporate governance mechanisms, audit fees and non-audit fees, the findings generated from this study are expected to assist policymakers in producing more evidence-based policies.

1.7 THE SCOPE OF THE STUDY

This study utilises all Islamic commercial banks licensed under the Bank Negara Malaysia. As of the end of 2017, there are 16 Islamic banks in Malaysia. The data related to audit fees, non-audit fees and corporate governance mechanisms which are collected for this research is the initial year of the implementation of GP1-i and SGF,