



**THE IMPACT OF REGULATIONS ON AUDIT
EFFORT AND EARNINGS QUALITY**

BY

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the degree of Master of Science in Accounting**

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ABSTRACT

The main purpose of this study is to examine the impact of the establishment of the Audit Oversight Board (AOB) on audit effort and earnings management. Specifically, it is argued that the monitoring role of the AOB leads to auditors being more rigorous in conducting audits so as to achieve high compliance with auditing standards. Thus, auditors have to put in more effort, which requires them to increase audit fees to compensate the increase in hours spent on an engagement. This study hypothesizes that an increase in audit effort should mitigate earnings management due to consequent higher detection. Besides the impact of the AOB, this study also examines the effect of the introduction of provisions 317A and 320A of the Capital Markets and Services Act (CMSA), the intention of which is to ensure the independent board of directors and audit committee are more effective in discharging their monitoring roles. It is also hypothesized that the level of earnings management should be reduced as a result of the more effective monitoring by independent boards of directors and audit committees. The data for the study is obtained from secondary data (annual reports). The final data sample comprises 2,124 observations collected from the annual reports of 708 firms for three years from 2009–2011, which covers the periods before and after the establishment of the AOB. The results indicate that there is an increase in audit effort from pre- to post-AOB. This suggests that the monitoring role of the AOB makes auditors more proper in carrying out the audit process and in collating supporting documentation. However, the regression analyses do not support the hypotheses except in relation to the role of board independence in reducing earnings management after the new regime was enforced. This study contributes to the corporate governance literature by examining the effect on financial reporting quality after the changes in rules and legislation, especially in respect of the audit regulatory system with the establishment of the AOB. This study is important as it provides some support for the argument that the failure of monitoring bodies to act diligently on behalf of the principal to reduce agency conflict could be solved by strict enforcement. Moreover, this study is conducted in Malaysia, which is a unique environment that offers a different perspective on the development of the AOB monitoring system and its role in the auditing process.

ملخص البحث

يهدف هذا البحث إلى دراسة تأثير إنشاء مجلس رقابة التدقي على جهود التدقيق وإدارة الكسب، وخصوصا بأنه يقال أن ضبط دور المجلس يؤدي إلى رفع مستوى الصرامة في أداء عمليات التدقيق من طرف المدققين وذلك لتحقيق درجة امتثال عالية مع معايير التدقيق. الأمر الذي يتطلب من المدققين زيادة أتعاب التدقيق لتعويض الزيادة في الجهد المبذول وساعات العمل التي يقضونها. هذه الدراسة تفترض أن الزيادة في جهود التدقيق ينبغي أن تخفف من إدارة الكسب كنتيجة لازمة لارتفاع مستوى الكشف. إلى جانب تأثير مجلس رقابة التدقيق، هذه الدراسة تبحث أيضا في تأثير إدخال الأحكام 317A و 320A لـ CMSA بهدف ضمان أن استقلالية مجلس الإدارة ولجنة التدقيق لهما أكثر فعالية في أداء مهامهما الرقابية. تفترض هذه الدراسة أيضا أن مستوى إدارة الكسب ينبغي أن ينخفض نتيجة لفعالية الرقابة المطبقة من طرف استقلالية مجلس الإدارة ولجنة التدقيق. تم الحصول على البيانات لهذه الدراسة من مصادر ثانوية (التقارير السنوية). تضم عينة البيانات النهائية 2124 مشاهدة والتي تم جمعها من التقارير المالية لـ 708 شركة لمدة ثلاث سنوات، من 2009 إلى 2011، والتي تغطي فترة ما قبل وبعد إنشاء مجلس رقابة التدقيق. تشير النتائج إلى أن هناك ارتفاع في جهود التدقيق من فترة ما قبل إنشاء المجلس إلى ما بعد إنشائه إشارة إلى أن الدور الرقابي للمجلس يجعل المدققين أكثر انضباطا في أدائهم. بالرغم من ذلك، تحليلات الانحدار لا تدعم سوى استقلالية مجلس الإدارة في الحد من إدارة الكسب بعد أن تم فرض النظام الجديد. يساهم هذا البحث في دراسات حوكمة الشركات من خلال دراسة التأثير على جودة التقارير المالية بعد التغييرات في القواعد والتشريعات وخاصة فيما يتعلق بقواعد نظام التدقيق مع تأسيس مجلس رقابة التدقيق. تكمن أهمية هذه الدراسة لدعمها لحجة أن فشل هيئات الرقابة للعمل بجد نيابة عن المدير للحد من صراع الوكالة يمكن حلها عن طريق التطبيق الصارم. تم إجراء هذه الدراسة في ماليزيا لأنها توفر بيئة فريدة من نوعها لوجهات نظر مختلفة حول تطور نظام مجلس رقابة التدقيق ودوره في عملية التدقيق.

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 investigation, 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.

Nur Fajrina Binti Che A Halim

Signature

Date.....

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In the name of Allāh, the Most Gracious,
the Most Merciful. I would like to dedicate
this dissertation to my beloved son,
parents, and late husband.

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LIST OF ABBREVIATIONS

AOB	Audit Oversight Board
CEO	Chief Executive Officer
CMSA	Capital Markets and Services Act
ISQC 1	International Standard on Quality Control 1
MIA	Malaysian Institute of Accountants
MCCG	Malaysian Code on Corporate Governance
PCAOB	Public Company Accounting Oversight Board
PIEs	Public Interest Entities
PLCs	Public Listed Companies
SCA	Securities Commission Act
SOX	Sarbanes Oxley Act

CHAPTER 1

INTRODUCTION

1.0 INTRODUCTION

This chapter provides an overview of the Master's dissertation on the impact of the Audit Oversight Board on audit effort and earnings quality. It is divided into six subsections. Section 1.1 provides the background, and this is followed by the problem statement, objectives, motivation and significance of the proposed study. The chapter ends with a description of the organization of the overall study.

1.1 BACKGROUND OF THE STUDY

The Audit Oversight Board (AOB) was established by the Malaysian Securities Commission in 2010. The objective was to improve audit quality and thus the quality of audited financial statements (Securities Commission, 2011a). In order to achieve this, the AOB was given the authority to monitor the auditors of public interest entities (PIEs) in Malaysia by conducting inspections of auditors of PIEs¹ to ensure their compliance with the relevant requirements, especially with the International Standard on Quality Control 1 (ISQC 1). Under this new regulatory regime, auditors need to ensure that sufficient evidence has been properly documented in audit working papers. It was expected that auditors would need to increase their audit efforts to meet this requirement. To compensate the increase in the auditor's burden under the new

¹ An entity which is of significant public interest because, as a result of the type of business, size or corporate status, that entity has a wide range of stakeholders. Such entities possess certain authority or enjoy a particular position in society where public accountability can be deemed to exist wherein it is likely that there may be sufficient stakeholders who base their resource allocation decisions upon their knowledge of such entities. Such entities include listed entities, non-listed public companies falling within the purview of the regulatory authorities such as the Securities Commission or Bank Negara Malaysia, or statutory bodies or government controlled entities that are of significant public interest, and which require audits (Malaysian Institute of Accountants, 2014),

regulatory regime, Recommended Practice Guide 7 (RPG 7) was revised to allow auditors to revise their fees to reflect the increase in time spent on the auditing process.

There are many factors that determine audit quality. One of the factors is highly dependent on the work done by auditors in order to form an appropriate audit opinion (Gul, 2006). Hence, auditors have to follow a suitable audit methodology to ensure that the evidence collected is appropriate and sufficient in order for them to provide a reasonable opinion that the financial statement is a true and fair representation of a company's financial condition. Basically, there are four typical steps in any audit process: (1) plan and design an audit approach, (2) perform tests of controls and substantive tests of transactions, (3) perform analytical procedures and tests of details of balances, and (4) complete the audit and issue an audit opinion. During the early phase, it is important for the auditor to assess the risk of misstatements in the financial statements in order to determine the level of audit effort (Gul, 2006). Thus, the purpose of an investigation by the AOB is to ensure that the audit process has been conducted properly by the auditors and that the appropriate evidence has been documented in audit working papers as proof of audit work done.

In addition, also in 2010, two new provisions (– Sections 317A and 320A – were incorporated into the Capital Markets and Services Act (CMSA), which empower the Securities Commission:

- i. “To prosecute directors and officers of listed firms for causing wrongful loss to a company”; and
- ii. “To prosecute anyone who coerces or influences the person responsible for preparing the financial statements of listed firms causing them to be materially misstated”.

These new sections give power to the Securities Commission to prosecute directors who are found guilty for dishonest conducts (Jayaseelan, Say & Tan, 2010). Prior to the issuance of these new sections, there has been no action taken against directors for breaching of his/her fiduciary duties (Jayaseelan et al., 2010). This enforcement is seen as a significant change because in the past Securities Commission could only deal with offences related to securities fraud or disclosure offences, but now, the Securities Commission has been empowered to take action on directors who fail to discharge their fiduciary duties that cause wrongful loss to the company (Jayaseelan et al., 2010).

It is often reported that prosecution on executive directors who had committed in white collar crimes, but there has hardly been any prosecutions on independent directors of listed companies for failure to discharging their oversight duty. It therefore indicates that there is no strict enforcement for breach of directors' fiduciary duties (Jayaseelan et al, 2010). As independent directors, they hold responsibility to properly monitor the corporate affairs because the public trusts and relies on them to provide honest and independent judgements. Failure to properly monitor the corporate affairs would also be one of the reasons for corporate failure; because it provides an opportunity for the management to engage in misconduct when they know that no one is overseeing their conduct (Fairfax, 2012). Hence, this new law would ensure independent directors on the board and audit committee to discharge their role more vigilantly. Failure to do so, may lead to the prosecution taken by the Secution Commission based on this new acts.

Therefore, with the establishment of the AOB and the introduction of two new provisions under the CMSA, it was expected that audit quality would be improved and that the oversight role of the board and audit committee would be enhanced to enable

the production of reliable financial reports. Hence, this study predicts that the increase in audit effort and the presence of more effective independent directors on the board and audit committee will reduce earnings management, which is a proxy for earnings quality.

1.2 RESEARCH PROBLEM STATEMENT

The issue of earnings quality has been the focus of extensive academic research since Ball and Brown's (1968) study on the informativeness of earnings because it involves the reliability and relevance of published accounting data. The issue of earnings quality surfaced again in the early 2000s when accounting irregularities were discovered in a number of large companies (for example, Enron and WorldCom in the US, Parmalat in Italy and Satyam in India). All these companies went bankrupt. Malaysia did not escape this type of scandal because two companies, Transmile Group Berhad and Megan Media Berhad, were also found to have used aggressive accounting practices to mislead investors. Transmile was found to have inflated its 2005 and 2006 revenues by RM400 million (Ex-Transmile, 2011), while Megan Media was found to have falsified its financial statements by RM1 billion in 2007 (Mahalingam, 2007). The share prices of these companies plunged following these disclosures. Megan Media went bankrupt in 2008, while Transmile's shares were delisted on 24 May 2011. While the shareholders of these firms lost billions of dollar and perhaps their life savings, the employees lost their jobs.

In the US, to curb aggressive accounting practices, the Sarbanes Oxley Act (SOX) was passed by the US Congress in 2002 and the Public Company Accounting Oversight Board (PCAOB) was formed. The major role of the PCAOB is to oversee the auditors of public companies. Its main objective is to protect the interests of

investors and further the public interest in the preparation of informative, fair and independent audit reports (Public Company Accounting Oversight Board [PCAOB], 2013). Following the Transmile and Megan Media scandals, Malaysia also established a version of the PCAOB, the Audit Oversight Board (AOB) on 1 April 2010. The AOB came into existence as a result of Parliament passing Part IIIA of the Securities Commission (Amendment) Act 2010 in December 2009, which specified the establishment and functions of the AOB (Securities Commission, 2011a). The AOB is empowered to investigate the audit process and documentation of auditors who audit PIEs. Thus far, two partners were reprimanded in 2012, six in 2013 and two in 2014 (Securities Commission, 2014). The offences mainly concern breaches of the AOB's registration condition under Section 31O (4) of the Securities Commission Act (SCA) 1993 (Securities Commission, 2014), which relate to the failure of auditors to comply with certain requirements of the International Standards on Auditing in discharging their professional duties in the performance of an audit of a PIE. Thus, due to stricter monitoring and penalties, it is expected that auditors will respond by increasing the extent of their audit scope and that this will be reflected in an increase in audit fees. The AOB expects that, as a result of its investigations, audit firms will improve audit quality by ensuring that sufficient effort is made during an engagement (Securities Commission, 2012a).

However, the production of high-quality financial reports is not only dependent on the quality of the audit service provided by external auditors, but also on a sound corporate governance mechanism where there is effective interaction between the actors in that mechanism. These actors include those charged with governance, namely, the board of directors and the audit committee; the management of the company; and the company auditor (Majella, 2012). After various notable corporate

scandals involving such companies as Enron, Worldcom and Xerox, the focus has been on strengthening the corporate governance mechanism in order to prevent earnings manipulation (Garcia-Meca & Sanchez-Ballesta, 2009). As suggested by Watts and Zimmerman (1986), corporate governance is one of the mechanisms that can improve the reliability and integrity of financial reporting by reducing the asymmetric information between managers and owners. At the same time, the importance of the audit committee in monitoring the external auditor's performance has been raised in relation to the collapse of some large companies (Majella, 2012).

Although many research studies have been conducted on the relationship between corporate governance and earnings management in developed economies, the results are mixed. Studies in the Malaysian setting also show mixed findings. Based on their review of various empirical findings, Garcia-Meca and Sanchez-Ballesta (2009) suggest that the contradictory results could be due to the fact that only certain dimensions of corporate governance have been tested (e.g., only testing internal governance without considering other external factors) or that diverse measurements have been used for some variables and/or that there is a variation in legal contexts. Thus, it is implied that changes in legislation should have an impact on corporate governance practices; as suggested by Hill and Jones (1992), the high credibility and strict enforcement of legislation should act as deterrence.

The Malaysian Code of Corporate Governance (MCCG) has been revised a few times: in 2000, 2007 and most recently in 2012. Despite the fact that the MCCG and Bursa Malaysia Listing Requirements have been amended several times to emphasize the role of independent directors and audit committees, it has been reported that regulators in Malaysia are not seriously pursuing action in relation to misconduct by directors (Jayaseelan, Say, & Tan, 2010). Although there is remarkable conviction

rates by Securities Commission, those directors and company officials who have been found guilty have only had to pay fines and these have not been commensurate with the extent of their misconduct (Jayaseelan et al., 2010). It may be that lax enforcement of laws in relation to the conduct of directors in Malaysia could explain the ineffectiveness of independent directors in mitigating earnings management (Jayaseelan et al., 2010).

Thus, in response to the ineffective level of enforcement (Jayaseelan et al., 2010), a new section – 317A – of the CMSA came into force on 1 April 2010. This provision empowers the Securities Commission to prosecute directors (and other company officials) for any breach of their fiduciary duties (Securities Commission, 2011b). Section 317A covers “prohibited conduct of director or officer of a listed corporation to do anything with the intention of causing wrongful loss to the company.” At the same time, Section 320A was introduced to “prosecute anyone who coerces or influences the person responsible for preparing the financial statements of listed firms causing them to be materially misstated.”

Therefore, given the establishment of the AOB and introduction of new regulations (317A and 320A) under the CMSA, it is of benefit to examine their impact on audit effort and on the effectiveness of the board of directors and audit committee in mitigating earnings management. Thus, this leads to the following research questions:

RQ1: Is audit effort increased in Malaysian listed companies following the establishment of the AOB?

RQ2: What is the impact of audit effort on mitigating earnings management in Malaysian listed companies following the establishment of the AOB?

RQ3: What is the impact of board and audit committee independence on mitigating earnings management following the introduction of Sections 317A and 320A of the CMSA in 2010?

1.3 OBJECTIVES OF THE STUDY

With reference to the above mentioned problem statement and research questions, the main objectives of the study are as follows:

- i. To determine whether audit effort increased following the establishment of the AOB;
- ii. To determine the impact of audit effort on mitigating earnings management following the establishment of the AOB; and
- iii. To determine whether independent boards of directors and audit committees are more effective in mitigating earnings management following the introduction of Sections 317A and 320A of the CMSA in 2010.

The first objective is linked to RQ1, which focuses on the pre- and post-AOB periods in order to evaluate whether there has been any increase in audit effort after the formation of the AOB. The second objective will answer RQ2. It is expected that the increase in audit effort will enable auditors to detect earnings management. The last objective will answer RQ3. It is expected that the new provisions of the CMSA will lead to more effective independent boards of directors and audit committees, and that as a consequence, earnings management should be mitigated. This study assumes that the presence of strong enforcement will have a positive impact on earnings quality.

1.4 MOTIVATION OF THE STUDY

The motivation of the study stems from the efforts of the Securities Commission to enhance the corporate governance of the Malaysian capital market among others through the establishment of the AOB and the introduction of Sections 317A and 320A under the CMSA. AOB is given the power to punish those auditors who failed to comply with auditing standards while these new sections under CMSA empower Securities Commission to prosecute directors who fail in discharging their duties diligently. This may indicate that our regulatory system is becoming stricter and it is supported by the International Monetary Fund and the World Bank which acknowledge the strong regulatory regime in Malaysia, shows that the Malaysian capital market's regulatory and supervisory framework is of high quality.

In addition, this study is also motivated to investigate these changes based on the framework of corporate governance and financial reporting quality suggested by Cohen, Krishnamoorthy, and Wright, (2004), who highlight the importance of having effective internal and external mechanisms in corporate governance. Thus, the impact of the AOB and other legislative changes on auditors, boards of directors and audit committees is the main focus of this study, which seeks to examine whether these changes have improved audit and earnings quality.

Furthermore, given the establishment of the AOB, auditors are required to conduct a more rigorous audit process and provide more thorough documentation of their audit work. They are also required to comply fully with ISQC 1. Failure to comply with ISQC 1 results in an investigation by the AOB, where after failure to rectify non-compliance leads to suspension of the audit licence and other related action by the AOB. As stated by the AOB, if audit work or evidence is not documented, it is assumed to have not been done. The partner of the audit engagement is expected to

ensure that the whole audit process and documentation is properly done by the audit team. Therefore, it is expected that auditors will need to spend more hours gathering audit evidence. More hours means that more audit effort is required by auditors, which then leads to an increase in audit fees. Besides, the amendment to RPG 7 to allow auditors to revise their audit fees under this new regulatory regime indicate that a high audit effort is necessary to provide high audit quality (MIA, 2013). Therefore, this study intends to examine whether there has been an increase in audit effort since the establishment of the AOB.

Moreover, this study is also inspired by prior research in developed countries such as in the United States (US) where many researchers have investigated the impact of PCAOB on earnings quality. In contrast, few studies on earnings management have been carried out in Malaysia and most of these were conducted before the AOB was formed, i.e., before 2010. Hence, given this new body and some new regulations, there is a need to conduct research on auditing in Malaysia in relation to audit quality, the corporate governance mechanism and financial reporting quality.

1.5 SIGNIFICANCE OF THE STUDY

This study focuses on the recent changes to the corporate governance regime in Malaysia, particularly in relation to auditors, which could be of special interest to those researching and practising accounting. Primarily, this study focuses on the establishment of the AOB in order to improve the audit quality of auditors engaged by firms in the Malaysian capital market. To the best of this researcher's knowledge, this study is the first to examine the impact of the AOB on the extent of audit effort and on earnings management.