

# **AUDIT COMMITTEE SUPPORT AND AUDITOR INDEPENDENCE**

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## **Abstract**

This study investigates whether audit committee do contribute towards external auditor independence. Audit committees are mandatory internal control mechanism required in all listed firms to ensure effective enforcement of good corporate governance. The results indicate that auditor independence is positively associated with audit committee meetings, audit committee report in the annual report, roles to approve and review audit fees, and composition of audit board. These results are consistent with the spirit of corporate governance code that was designed, among others, to improve the quality of financial reporting and hence increase confidence in the information presented in the reports.

**Keywords:** Audit Committee, Auditor Independence, Bursa Malaysia, Perceptions, Compliance

# AUDIT COMMITTEE SUPPORT AND AUDITOR INDEPENDENCE

## 1.0 Introduction

The Malaysian Code on Corporate Governance (MCCG) postulates that “an independent audit committee (AC) serves to implement and support the oversight function of the board in several ways”<sup>1</sup> (FCCG, 2000, p. 38). Indeed, audit committee is appropriate to undertake the board of directors roles in providing “focused review and detailed discussion of the company’s processes for producing financial data, its internal controls, *and independence of its external auditor*”, which it “might be too time-consuming for the full board” (FCCG, 2000, p. 36). This paper investigates the role of audit committee and their support for auditor independence. An independent audit committee enhances the independence of external auditor, and ensures that auditor is free from management influence. The committee will conduct informal and private meetings without the presence of company’s management to encourage the external auditor to be transparent on material issues at an early stage.

The concept of an AC has evolved over many years across developed countries and now has become a mandatory listing requirement in most stock exchanges worldwide. In Malaysia, the new code of corporate governance and the amended stock exchange’s listing requirement provide evidence on the importance of audit committees in ensuring transparency of information and quality financial reporting.

There are many aspects of audit committees that could be explored in the context of support for good corporate governance practices in the corporate sector. This paper, focuses on the impact of audit committee support (i.e. meeting, report, role to approve audit fees, role to review audit fees, composition) on external auditor independence. It is expected that an effectively functioning audit committee will contribute towards auditor independence and hence ensures the quality of financial reporting.

The next section discusses the documented evidence on this issue in previous studies, followed by research design in section 3. The findings are discussed in section 4, while the conclusions are summarized in section 5.

## 2.0 Previous Evidence

Documented evidence on effectiveness of audit committees in enhancing good corporate governance have focused on various aspects, but the issue of interest in this paper is the support of audit committee in enhancing auditor independence (Beattie *et al.*, 1999; Collier, 1992; Dockweiler *et al.*, 1986; Fearnley and Beattie, 2004; Jackson-Heard, 1987; Knapp, 1987; Mautz and Newman, 1970). Knapp (1987) discovered that an audit committee is more likely to support the auditor instead of management in audit disputes and the level of support is consistent across members of the audit committee, regardless of whether the member is in a full time or part time position, such as corporate managers, academicians and retired partners of CPA firms. Pearson (1980) and Dockweiler *et al.* (1986) showed that auditors’ reliance on management is reduced due to the direct communication with the audit committee.

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<sup>1</sup> In Malaysia, the MCCG defined independent of directors “broadly to two crucial aspects - independence from management and independence from a significant shareholder” (FCCG, 2000, p. 25).

The formation of an audit committee would improve financial statements' credibility and reliability through providing assurance on the objectivity of financial statements to shareholders (AICPA, 1967; Auerbach, 1973; FCCG, 1999). Lam (1976) found that the appearance of independence of the committee would enhance auditor independence and improve transparency in financial reporting.

Beattie *et al.* (1999) reported that audit partners, finance directors and financial journalists believed that audit committee with independent non-executive directors strongly encourage auditor independence. Independent directors of audit committees are expected to increase the quality of monitoring because they are not associated with the company either as officers or employees; thus, they would act as the shareholders' watchdog. Raghunandan *et al.* (2001) and DeZoort and Salterio (2001) revealed that audit committees that consist of qualified independent directors are better able to contribute towards auditor independence.

Shamsher *et al.* (2001) found that a large majority of companies listed on the Malaysian stock exchange tend to comply with all regulations imposed on them, such as the requirement to disclose audit committee reports, without much concern for the quality of these reports. This implies adversely on the corporate governance practice, auditor independence and hence quality of financial reporting.

### **3.0 Methodology**

To gather the required information, 300 questionnaires (that were pre-tested) were distributed to senior managers of finance and accounting division of Malaysian public listed companies. The questionnaires were designed to collect information on five main aspects of audit committees that are perceived to be associated with auditor independence, such as the composition of the committee, the level of activeness, the preparation of reports, the activities relating to audit fees reviews and approval. The response rate was 36%, which is considered adequate and consistent with recommendation made by expert in prior studies (see Table 1). The respondents selected were responsible for the auditing, accounting and finance function in their firm. The seniority of the respondents provides better validity to the information gathered for analysis.

#### **Table 1 about here**

Structured interviews were also conducted with senior managers to further clarify issues, seek their perception and insights on the relationship between audit committee activities and the impact on auditor independence (see Table 2).

#### **Table 2 about here**

For the purposes of better understanding of perceptions given by respondents from different size of companies, the respondents were stratified based on size of their companies<sup>2</sup>. Two approaches were taken; (1) classification based on their listing status i.e. main and second board, (2) classification based on size of companies on

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<sup>2</sup> This procedure was made possible by differentiating the colour of questionnaires cover. Prior to distributing the questionnaire, respective companies' market capitalisation was gathered and they were grouped into the appropriate size classification.

their respective boards. For companies listed on the main board counter, those with market capitalization above RM3 million were grouped as Top Tier, those with market capitalisation between RM1.5 million and 3 million were classified as Medium Tier and those with market capitalisation below 1.5 million were treated as Low Tier. On the other hand, second board companies were classified as follows: Top Tier (market capitalisation greater than RM135,000), Medium Tier (market capitalisation between RM80,000 and RM135,000), Low Tier (market capitalisation below RM80,000). The frequencies of responses to the questionnaire distributed are reported in Table 3.

### **Table 3 about here**

The possibility of occurrence of non-response bias arises when some of the survey sample failed to return the questionnaire and the data may consequently turn out to be invalid<sup>3</sup>. To ensure the reliability and validity of the data, an attempt to diagnose the presence of non-response bias is essential (see Bartlett and Chandler, 1997; Mallin and Ow-Yong, 1998). Based on the technique recommended by Oppenheim (1966) and Wallace and Mellor (1988), the first 20 questionnaires were compared with the last 20 questionnaires. The Mann-Whitney test was employed as a statistical tool to investigate the differences. No significant differences were observed between the 20 early and 20 late responses, implying the absence of non-response bias.

Another source of bias in survey-type studies is self-selection bias (Eysenbach and Wyatt, 2002; Oppenheim, 1992; Whitehead, 1991)<sup>4</sup>. The bias might arise from the fact that “people are more likely to respond to a questionnaire if they see items which interest them” (Eysenbach and Wyatt, 2002) and “they may try to ‘respond’ extra-well” (Oppenheim, 1992, p.30) to the questions. Although no specific approach to identify self-selection bias has been documented, this study employed two techniques. First, two groups of control and experimental respondents were developed (Oppenheim, 1992). The control group consisted of respondents with more than 10 years’ experience, while the experimental group comprised of respondents with less than 10 years’ experience. Using the Mann-Whitney test, responses were examined, and the distribution of responses of the two groups in all respondent classifications was not significantly different, indicating that the effect of self-selection response bias was minimal or non-existent. Second, since this study employed both questionnaire and interview survey approaches, the results of interview survey tend to confirm the questionnaire survey in all variables examined. The consistency of responses in both approaches indicates minimal or non-existent self-selection response bias.

## **4.0 Results**

It is widely perceived that the presence of an audit committee will add value to corporate financial reporting and enhance communication network between auditors and management (Spira, 1999; Klein, 2002; Zulkarnain and Shamsher, 2007). An effectively functioning audit committee will provide an oversight function consistent with corporate best practice, and will ensure a fair level of auditor independence. The

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<sup>3</sup> It is well recognised in the literature that responses to mail questionnaires are generally poor, and it is a common phenomenon to see return percentages as low as between 30 to 50% (Wallace and Mellor, 1988, p. 132).

<sup>4</sup> Oppenheim (1992, p.30) termed this phenomenon as ‘volunteer bias’.

respondents were asked to indicate their views on the five issues relating to audit committees and the possible impact on auditor independence, the results are tabulated in Tables 4, 5 and 6 below.

**Table 4 about here**

**Table 5 about here**

**Table 6 about here**

#### **4.1 Active Audit Committee**

An active audit committee would indicate the level of effort that has been made to ensure good financial reporting. Information in Table 4 indicates that the majority of the senior managers of the main board (79%) and second board (92%) companies agreed with the suggestion that an active audit committee would have better chance of safeguarding auditor independence. The positive responses by the majority of the respondents indicate their trust in actively functioning audit committees in ensuring quality of financial reporting, consistent with findings in the developed markets (e.g. Bedard *et al.*, 2004; DeFond and Jiambalvo, 1991). The more meetings held by the committee indicate that the members of the committee are putting more effort to monitor business transactions and to make sure the internal control is working as intended.

There was a significant difference between perception of senior managers of main and second board companies, perhaps the differences in perceptions indicate the strength of their belief in active audit committees to perform. The senior managers of second board companies indicated more trust in active audit committees to support auditor independence than the senior managers in the main board companies. The perception could stem from the fact that the second board companies face higher risk and are more aggressive in conducting their business operations. Thus, more control is needed compared to the main board companies that are more stable in their business operations. Further analysis based on size of main and second companies indicate no significant differences in perceptions across the groups (see Tables 5 and 6).

The findings on the same issue from personal interviews were consistent with the questionnaire survey findings. The majority of the interviewees (i.e. 59% of the senior managers of public listed companies) agreed that active audit committees would safeguard auditor independence. The interviews disclosed the view that audit committees' scope as overseers should be expanded, given the current rapidly changing structure and sophistication of the economy. It was suggested that the committees should spend "much more time" performing their duties, in order to meet public expectations and keep up with fast changing and complex business environment. In light of increasing business risks due the sophisticated business environment, the system of financial reporting and oversight is being stretched and challenged, and close scrutiny especially by the auditor and audit committee is now a necessity. Perhaps, the more meetings conducted by audit committees indicate their commitment in carrying out their assigned responsibilities.

#### **4.2 Compulsory Audit Committee Reports**

A clear majority of the respondents in the main (78%) and second (74%) board companies agreed with the suggestion that auditor independence would be safeguarded if audit committee reports were to be made compulsory in the annual report (refer to Table 4). The responses might reflect their belief that the public would gain from the information in audit committee reports. Further analysis on the different perceptions between different size of companies in the main and second board indicate that there is significant difference (at 5% level) between the Tier 1 and Tier 3 companies in the main board (see Table 4). Panel A of Table 4 shows that managers of large companies (i.e. based on market capitalisation) have a strong belief that audit committee report could add value to auditors' role and thus enhance their independence.

Regarding the issue of audit committee reports, the majority of the interviewees (i.e. 88% of the senior managers of public listed companies) disclosed that audit committees should present their reports as part of the company's financial statement, which is consistent with the findings in the questionnaire survey. Although the exchange (Bursa Malaysia Berhad) requires public listed companies to include audit committee reports as part of their annual report, the majority of the interviewees are concern on the contents of the report that only outline their terms of reference and expected duties to be undertaken to comply with the Code of Corporate Governance, rather than what actions have been taken or any material transactions have been found to be inconsistent with expectation and practice. Most of the interviewees indicate that audit committee reports should cover issues of risk areas, exceptional items, business risks, and threats arising from technology changes.

#### **4.3 Approval and Review of Audit Fees by Audit Committees**

Capital market participants are increasingly concerned about the potential threats or pressure received by auditors during their negotiation of audit fees with the management of client companies. Therefore, the problem might be reduced if audit committees were to undertake the role of approving audit fees. Table 4 shows that 53% and 46% of the senior managers of main and second board companies respectively agreed with the idea that auditor independence would be safeguarded if audit committees were to assume the role of approving audit fees. The responses are consistent with the notion that independent committee should have a role in the decision involving auditors to avoid opportunities for management to exercise their influence during the negotiation of fees (see Abbot and Parker, 2000).

Findings from the interviews are also consistent with that of the questionnaires, with, more than half of the interviewees (i.e. 53%) agreed that auditor independence would be strengthened if auditors were given the responsibility to review and approve audit fees. The interviews disclosed that the management might influence auditors or apply some form of pressure on their negotiation of audit fees. The interviewees indicated that audit committees could play a critical role in the financial reporting process by acting as intermediaries, having the power to review and approve audit fees, and as a result, helping auditors to maintain their independence.

#### **4.5 Audit Committee Members**

It has been perceived that audit committees can function effectively if its members mostly comprised of independent directors (Abbott *et al.*, 2001; Klein, 2002). The

majority of the managers of main (90%) and second (85%) board companies agreed with this perception (refer to Table 4). The responses suggest that independent directors would be expected to provide a balanced and independent view, can be impartial when dealing with the role of external auditor. Directors who lack this 'independence' criterion may be unable to pursue their role as internal enforcers of good financial reporting (Anwar, 2003).

Consistent with the questionnaire survey, the findings from the interviews (i.e. 65%) agreed that the exchange listing requirements on the composition of audit committee members (i.e. majority of independent directors) would strengthen the role and independence of these committees and consequently safeguard auditor independence. In fact, listed companies are required to appoint the majority of their audit committee members from independent non-executive directors who have no interest in the companies. The interviews disclosed that independent non-executive directors would enhance the oversight role of the committee by asking probing questions and refusing to tolerate simple answers. The interviewees indicated that independent scrutiny of the company's financial statements would support the role of auditors. The interviews revealed that the right mix of audit committee members is essential and a committee with qualified members from all walks of life with hands-on knowledge of the company's business will be able to perform its responsibilities effectively.

## **5.0 Conclusion**

The questionnaire survey and the interviews revealed that the majority of the respondents agreed that auditor independence would be safeguarded by the presence of an active audit committee, mandatory inclusion of audit committee report in the annual report, making audit committees responsible to review and approve audit fees, and if the majority of audit committee members were independent and non-executive directors. This indicates that the respondents have faith in the audit committees to facilitate good corporate governance practices, specifically in this research to enhance communication between auditors and management. An active audit committee is important because it will indicate the commitment to the issues of interest. Audit committee reports show activities undertaken during the financial year and also report the efforts made to ensure adequate internal control. The majority of the respondents agreed that audit committee should be given the role to approve and review audit fees, thus neutralise the imbalance or biasness of management influence in the negotiations with the auditors. Finally, the respondents agreed that auditor independence would be safeguarded if audit committees were made up of a majority of independent and non-executive directors, and this might indicate that their independent status would contribute to auditor independence through bridging communication networks, and would neutralise any conflict between the management and the auditor.

The interview survey confirmed the questionnaire survey's findings that the presence of an audit committee could safeguard auditor independence. The main concern raised by the interviewees was the ability of the committee to act independently and ask probing questions. Ideally, the committee should consist of highly qualified and committed people. A strong and impartial audit committee would support the auditor in situations of conflict or disagreement over accounting principles and enhance their ability to resist management pressure. Overall, the findings are consistent with expectations and documented evidence in developed economies that audit

committees, given certain requirements that the committee must have, can play an effective role to ensure external auditor independence.



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## Appendix 1

Table 1: Analysis of Responses by Respondent's Category						
Category	Total Questionnaires Issued	Usable Responses Received Pre-reminder	Usable Responses Received Post-reminder 1	Usable Responses Received Post-reminder 2	Total Usable Response	Total Usable Response Rate
	Frequency	Frequency	Frequency	Frequency	Frequency	%
Public Listed Companies	300	42	16	49	107	36

Table 2: Interview Survey				
Management	Number of Managers Interviewed	Job Description of Interviewee	Listing Status	Experience in Function
M1	2	Finance Manager	Second Board	10
		Financial Accountant	Second Board	10
M2	1	Vice President	Main Board	26
M3	1	Finance Manager	Second Board	12
M4	1	Chief Internal Audit	Second Board	12
M5	1	Assistant General Manager	Main Board	20
M6	1	Finance Director	Main Board	28
M7	1	Chief Internal Audit	Main Board	14
M8	1	Assistant General Manager	Second Board	15
M9	1	Chief Internal Audit	Main Board	8
M10	2	Chief Financial Officer	Main Board	20
		Senior Manager	Main Board	20
M11	1	Chief Financial Officer	Second Board	15
M12	1	Vice President	Main Board	24
M13	1	Chief Internal Audit	Main Board	25
M14	1	General Manager	Second Board	14
M15	1	Finance Director	Main Board	27
<i>Average of Years of Experience</i>				17.65

<b>Table 3: Analysis Showing Frequency and Criteria of Sample Partitioned</b>		
<b>Panel A: Main Board of Public Listed Companies</b>		
<b>Listing Status</b>	<b>Criterion</b>	<b>Frequency</b>
	<b>Market Capitalisation</b>	
Top Tier	>RM3 Million	18
Medium Tier	>1.5 Million, < 3 Million	21
Low Tier	<1.5 Million	29
<b>Total</b>		68
<b>Panel B: Second Board of Public Listed Companies</b>		
<b>Listing Status</b>	<b>Criterion</b>	<b>Frequency</b>
	<b>Market Capitalisation</b>	
Top Tier	>135,000	10
Medium Tier	>80,000, <135,000	18
Low Tier	<80,000	11
<b>Total</b>		39



**Table 4: Analysis Showing Perceptions on Issues on Audit Committee Analysed By Public Listed Company's Listing Status**

Analysis By Listing Status Category									
	Main Board (N=68)				Second Board (N=39)				Significance
The following audit committee issues may enhance auditor independence if:	Disagree %	No View %	Agree %	Mean	Disagree %	No View %	Agree %	Mean	
Active audit committee	6	15	79	2.74	0	8	92	2.92	*
Compulsory audit committee report	6	16	78	2.72	0	26	74	2.74	NS
Audit committee approves audit fees	6	41	53	2.47	3	51	46	2.44	NS
Audit committee reviews audit fees	6	46	49	2.43	5	64	31	2.26	NS
Majority independent and non-executive directors	0	10	90	2.90	0	15	85	2.85	NS
***, **, *, NS Indicates distribution of responses between main board and second board companies respondents is significantly different at the 1%, 5% and 10% level and not significant respectively (using the Mann-Whitney test).									

**Table 5: Analysis Showing Perceptions on Issues on Audit Committee Analysed By Size of the Main Board Companies**

Panel A: Analysis by Main Board Company's Size													
	Tier 1 (N=18)				Tier 2 (N=21)				Tier 3 (N=29)				Significance
The following audit committee issues may enhance auditor independence if:	Disagree %	No View %	Agree %	Mean	Disagree %	No View %	Agree %	Mean	Disagree %	No View %	Agree %	Mean	
Active audit committee	0	11	89	2.89	5	10	85	2.81	9	22	69	2.59	NS
Compulsory audit committee report	0	6	94	2.94	5	19	76	2.71	10	21	69	2.59	NS
Audit committee approves audit fees	5	28	67	2.61	9	48	43	2.33	3	45	52	2.48	NS
Audit committee reviews audit fees	5	39	56	2.50	10	52	38	2.29	2	46	52	2.48	NS
Majority independent and non-executive directors	0	0	100	3.00	0	14	86	2.86	0	14	86	2.86	NS
***, **, *, NS Indicates distribution of responses between Tier 1, Tier 2 and Tier 3 respondents is significantly different at the 1%, 5% and 10% level and not significant respectively (using the Kruskal Wallis test).													

**Table 6: Analysis Showing Perceptions on Issues on Audit Committee Analysed By Size of the Second Board Companies**

Panel A: Analysis by Second Board Company's Size													
	Tier 1 (N=10)				Tier 2 (N=18)				Tier 3 (N=11)				Significance
The following audit committee issues may enhance auditor independence if:	Disagree %	No View %	Agree %	Mean	Disagree %	No View %	Agree %	Mean	Disagree %	No View %	Agree %	Mean	
Active audit committee	0	10	90	2.90	0	11	89	2.89	0	0	100	3.00	NS
Compulsory audit committee report	0	20	80	2.80	0	33	67	2.67	0	18	82	2.82	NS
Audit committee approves audit fees	10	50	40	2.30	0	61	39	2.39	0	36	64	2.64	NS
Audit committee reviews audit fees	10	70	20	2.10	6	61	33	2.28	0	36	64	2.36	NS
Majority independent and non-executive directors	0	30	70	2.70	0	11	89	2.89	0	9	91	2.91	NS
***, **, *, NS Indicates distribution of responses between Tier 1, Tier 2 and Tier 3 respondents is significantly different at the 1%, 5% and 10% level and not significant respectively (using the Kruskal Wallis test).													

