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Do political connections affect the role of independent audit committees and CEO Duality? Some evidence from Malaysian audit pricing ☆

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ABSTRACT

This study examines whether political connection to firms affects the association between audit committee independence and demand for higher quality audits. In line with Carcello et al. (2002), our findings show that there is a positive association between audit committee independence and audit fees thus supporting the hypothesis that more independent audit committees demand higher audit quality. However, we find that this relationship is weaker for politically connected (PCON) firms suggesting that the independence of audit committees in Malaysian PCON firms may be compromised. Additionally, we provide evidence that PCON firms that have CEO duality are perceived by audit firms as being of higher risk than CEO duality firms without political connection.

1. Introduction

Particularly identified in Asia (Li and Atuahene-Gima, 2001), the link between political connections and firm performance has been investigated in a number of studies. Some studies find political connections positively related to firm performance/value (Nee, 1992; Peng and Luo, 2000; Fisman, 2001) while others come to a different conclusion (Fan et al., 2007). Of particular interest is the study by Johnson and Mitton (2003) suggesting that the political connections of Malaysian firms may affect transparency in that information concerning expropriation or bribes may be hidden to disguise the poor performance of such politically connected (PCON) firms. Further, PCON firms, besides having the traditional agency costs, also have to bear the costs of catering to the interests of the political party/entity to which they are affiliated (Micco et al., 2007). The risk is that to preserve and serve this political relationship, members of the management who produce financial reports may manage earnings to serve the interests of their political allies at the expense of other stakeholders, such as the shareholders and creditors. This consideration is likely to affect an auditor's perception of a PCON firm's business risk. Hence, the suggestion by Gul (2006) that political connections affect audit fees: PCON firms seemed to be associated with higher audit risks and consequently were charged higher audit fees. More recently, Chaney et al. (2009, p. 58) in a cross-country study provide evidence that PCON firms have a significantly lower quality of earnings. It may well be that PCON firms disclose lower quality information due to their having a "lesser need to respond to market pressures to increase the quality of (such) information" (Chaney et al., 2009, p. 58).

In this study, we extend this line of research. We investigate how audit pricing is affected by ***both*** political connections and the operation of two firm level corporate governance constructs: board committees and CEO duality (where the chief executive officer and the chairperson of the board is the same person). Both these constructs were specially identified in

☆ Data Availability: Data is available from the Annual Reports of the sample firms used in this study.

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the Malaysian Code on Corporate Governance (MCCG)[1] recommendations. Moreover, anecdotal evidence and newspaper reports suggest that these two constructs were particularly problematic for Malaysian firms. More specifically, this study examines whether (1) the independence of the audit committee, and (2) the presence of CEO duality affect audit fees, and whether this association is moderated by political connections. We adopt both a supply-side (Gul and Tsui, 1998) and demand-side (Carcello et al., 2002) perspective to examine the link between these variables and audit fees.[2] The well documented existence of PCON firms in Malaysia and data thereon (Gomez and Jomo, 1997; Johnson and Mitton, 2003; Gul, 2006; Faccio, 2006)[3] provides us the opportunity to test these relationships.

Independent directors are associated with the demand for higher quality audits. North (1996) and Gul (2006) are among those who argue that as PCON firms are associated with higher agency costs and more rent seeking activities, it is likely that the demand for higher quality audits will be weaker from the independent directors of PCON firms. Our motivation to examine this link may be traced to Carcello et al. (2002, p. 381) who provide evidence that more independent boards demand higher audit quality and are prepared to pay for a more expensive (and expansive) audit. Whilst we expect a positive association between the independence of directors on audit committees and audit fees, we test whether political connections affect this association. In other words, we test whether political connections affect the audit committee's demand for higher quality auditing (Carcello et al. 2002). CEO duality is associated with higher agency risks which results in auditors having to exert greater audit efforts. This leads us to test whether political connections affect the association between CEO duality firms and audit fees. Evidence on this point is not available in the literature.

The sample comprising of the top 500 Malaysian public companies is chosen for a number of reasons. The first is the interesting and somewhat unique feature of the Malaysian corporate landscape – the well documented existence of PCON firms. Second, testing the independence of directors on audit committees in Malaysian PCON firms is consistent with the growing worldwide importance of the role of the audit committee in enhancing corporate governance.[4] This is seen in the US by the Sarbanes-Oxley Act (2002) (SOX) that aimed to strengthen the position of the audit committee as a means of improving corporate governance.[5] Weaknesses in corporate governance were also touted as a likely cause of the Asian financial crisis to which claim the Malaysian government responded by enacting the MCCG that came into force from the financial year ending 30 June 2001. The MCCG recommended that firms comply with a number of prescriptions aimed at enhancing corporate governance by promoting "best practices".[6] To ensure compliance with the MCCG, the Listing Requirements of the Bursa Malaysia (para. 15.26) required that all listed firms state in their annual reports (1) how they apply the principles, (2) the extent to which they comply with the set out best practices, and (3) reasons for areas of non-compliance that they identified.[7] A major requirement in the MCCG is that firms have a predominantly independent audit committee.[8] Additionally, the MCCG advocates the avoidance of CEO duality.[9] Third, the SOX, by enhancing the degree to which the directors of US firms were legally liable for their actions, also enhanced the likelihood of their being sued. Whilst there is no comparable common law or legislative provision in Malaysia the provisions of MCCG suggest to Malaysian directors and managers that they too would be subjected to a more exacting standard. Fourth, the MCCG has made the Malaysian corporate environment somewhat unique by effectively mandating that the majority of the members of the audit committee (and not all, as in other jurisdictions) must be independent.[10] As argued by Gul (2006, p. 932), a study such as this set in a country with such a unique setting addresses the confounding effects often besetting cross-country studies as identified by Miller (2004). The association of audit committee and audit fees has been studied mainly in non-Asian countries, predominantly in the US, Britain and Australia (e.g. see Engel et al., 2010; Goddard and Masters, 2000; Goodwin-Stewart and Kent, 2006). Fifth, unlike corporations in the US, Malaysian firms appear to be more influenced by the recommendation of the Cadbury Committee (1992) against CEO duality than by the likes of SOX. The fact is that just over 12% of this sample firms from Malaysia have CEO duality. By contrast, up to 80% of the firms in a similar US sample would have CEO duality.[11]

1 The MCCG is discussed at pages 2 of this paper.

2 The demand-side perspective occurs when the client firm demands for a higher audit quality while the supply-side perspective occurs when the auditor supplies higher audit effort in response to audit risks.

3 Firms in this current study are identified as being politically connected if they have previously been identified as such in either Johnson and Mitton (2003) or Faccio (2006).

4 The audit committee's responsibilities include the appointment and removal, compensation, and oversight of the work performed by the auditor. This makes it an appropriate vehicle for the investigation of director independence in relation to audit fee pricing.

5 In particular, SOX sec. 204 (2) that mandates the auditor reports to audit committees any departures from generally accepted accounting principles and the ramifications of such alternative treatment, and the preferred treatment by the audit firm.

6 The aim of the MCCG was to 'set out principles and best practices....towards achieving the optimal governance framework' (para. 1.3). It should be noted that whilst this study focuses on the MCCG prescriptions concerning increased audit committee effectiveness, and CEO duality, the Code imposes other requirements relating to the Board of Directors and its responsibilities, remuneration, and other areas that are not within the scope of this study.

7 Should a firm fail to disclose required matters in compliance with the MCCG, Bursa Malaysia can take action to de-list the firm (para. 16.11).

8 Audit committees have been mandatory under Malaysian listing rules since 1994. Note that other than requiring disclosure of non-compliance with the MCCG, the implementation of the MCCG did not increase disclosure requirements of a firm's corporate governance.

9 MCCG (para. AA, II) concerning CEO duality prescribes that there 'should be a clearly accepted division of responsibilities...(to) ensure a balance of power and authority, such that no one individual has unfetted powers of decision' and that when CEO duality is present 'there should be a strong independent element on the board', and that such a practice should be publicly explained. The Code adopts best practice prescriptions of the Cadbury Committee Report and the Greenbury Report.

10 MCCG para. BB1.

11 Brickley et al. (1997) found approximately 81 percent of their sample firms had CEO duality. A survey conducted by McKinsey & Co. report that 75 percent of S&P 500 companies had CEO duality in 2002 (Kim et al., 2009).