ASIAN ACADEMY *of* MANAGEMENT JOURNAL *of* ACCOUNTING *and* FINANCE

AAMJAF, Vol. 7, No. 1, 1–27, 2011

AUDIT FEES IN MALAYSIA: DOES CORPORATE GOVERNANCE MATTER?

Effiezal Aswadi Abdul Wahab[1*], Mazlina Mat Zain[2] and Kieran James[3]

[1]Graduate School of Business, Universiti Sains Malaysia 11800 USM Pulau Pinang, Malaysia
[2]Faculty of Management, Multimedia University, Jalan Multimedia
63100 Cyberjaya, Selangor, Malaysia
[3]School of Accounting, Economics and Finance, University of Southern Queensland
Toowoomba QLD 4350, Australia

[*]Corresponding author: effiezal@usm.my

ABSTRACT

This study examines the relationship between corporate governance and audit fees during the period before and after the enactment of the Malaysian Code of Corporate Governance (MCCG). Our panel analysis of 379 firms during the 1999–2002 period reveals a significant and positive relationship between corporate governance and audit fees. However, the relationship becomes weaker after 2001, suggesting that the MCCG reduced firms' control and inherent risk, thus ultimately contributing to reduced audit effort in Malaysia. Our findings remain viable after we control for political connections unique to Malaysia's capital market.

Keywords: Corporate governance, audit fees, corporate governance reform, political connection, MCCG

INTRODUCTION

Corporate governance has been highlighted in Malaysia since the Asian Financial Crisis of 1997–1998. The Kuala Lumpur Stock Exchange/Price Waterhouse (KLSE/PwC) joint survey commissioned in 1998 by Malaysia's Ministry of Finance found that 94% of surveyed firms desired a reform of Malaysia's corporate governance regime, citing the need for investors' confidence, transparency in directors' dealings, protection of minority shareholders, and an emphasis on directors' fiduciary duties. Subsequently, in 1998, the Malaysian Government formed the Finance Committee on Corporate Governance (FCCG). This committee recommended the passage of the Malaysian Code on Corporate Governance (MCCG) in 1999. After a brief 'self-regulatory' period, the MCCG became a part of the Kuala Lumpur Stock Exchange (KLSE) Listing Rules in

2001. Studies, not unique to Malaysia, have shown that the enactment of corporate governance codes actually enhances the corporate governance mechanisms that firms use.

In this study, we examine the relationship between corporate governance and audit effort, proxied by audit fees, during the 1999–2002 period. We expect a positive relationship between corporate governance and audit fees in the pre-MCCG period because firms with good governance are more likely to purchase more audit effort. We also examine whether the relationship between corporate governance and audit fees holds after the MCCG reform.

Our study contributes to the corporate governance and audit fees literature by examining a large number of corporate governance variables that are based on the MCCG, instead of on several individual governance variables such as audit committee, board structure or composition, and shareholder protection. We 'condense' the corporate governance variables into a single governance index in a manner similar to other corporate governance studies such as Gompers, Ishii and Metrick (2003), Bebchuk, Cohen and Ferrell (2009), Klapper and Love (2004), Durnev and Kim (2005), and Brown and Caylor (2006). In addition, we examine a 'forced catalyst' to changes in firms' corporate governance structure (i.e., the MCCG). Because these changes may be cosmetic or 'legalistic' in some firms (i.e., they occur without any genuine change in corporate culture), an interesting question is whether audit firms *price* these changes.

We find a positive relationship between corporate governance and audit fees. However, the positive slope of the association between corporate governance and audit fees weakens after the reform. We view this unexpected finding as important because it suggests that corporate governance reforms play a major role in increasing investor confidence and reducing the firms' perceived control and inherent risk. Moreover, this seems to occur at the economy-wide level. A 'supply-side' effect, rather than a 'demand-side' effect as in the pre-MCCG period, seems to be the primary market force causing this slope to become less steep after the reform. We thus see a combination of demand- and supply-side effects at work in our empirical data.

INSTITUTIONAL BACKGROUND

Corporate Governance Environment in Malaysia

The MCCG is largely derived from the recommendations of the 1992 Cadbury Report and the 1998 Hampel Report in the United Kingdom, although the MCCG tends to be more regulatory driven (Ow-Yong & Kooi Guan, 2000). The MCCG

was first issued in March 2000. It was developed by the *Working Group on Best Practices of Corporate Governance (JPK1)* which is composed of members from the public and private sectors, and the Code was subsequently approved by the High Level Finance Committee. The MCCG formally defines corporate governance as:

> The process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking into account the interest of other stakeholders (FCCG, 1999, Para. 1.1, p. 52).

The MCCG's recommendations are divided into four main parts: Part (1) *Principles of Corporate Governance*; Part (2) *Best practice in Corporate Governance*; Part (3) *Principles and Best Practices for other corporate participants*; and Part (4) *Explanatory notes.*

Part (1) *Principles* addresses four main issues: board of directors, directors' remuneration; shareholders; and accountability and audit. A narrative statement in the annual report regarding the application of relevant principles is considered a sufficient disclosure from which investors can assess firms. Part (2) *Best practices* provides a set of guidelines or practices relating to the board of directors, accountability, and auditing concerns to assist firms in designing their approach to corporate governance. Compliance to Part (2) is voluntary, but firms are required in their annual reports to state the extent of their compliance with these practices and to explain any departure from them (Subramaniam et al., 2009). Part (3) *Exhortations to other participants* is addressed primarily to institutional investors and auditors and is aimed at enhancing their role in corporate governance. Part (4) *Explanatory notes* further explains the other three parts.

While the MCCG is intended to be a voluntary, non-statutory and self-regulatory guide, Bursa Malaysia strengthened efforts towards enhancing corporate governance practices in Malaysia by integrating the Code in its Listing Requirements. For instance, Chapter 15 of the revamped Listing Requirements specifically addresses corporate governance issues; particular recommendations of the MCCG have now become integral parts of the revamped Bursa Listing Rules. Further, the listing rules require firms listed on Bursa Malaysia to state their extent of compliance with the MCCG, and disclosure notes are required in the annual reports to explain any departure from the Code. Failure by an entity to make the necessary disclosures and the disclosure of false information are considered non-compliance and punishable under the listing rules. In other

words, Bursa Malaysia and the MCCG have established expectations of accountability that include greater transparency and disclosure requirements (Mohd Ghazali & Weetman, 2006).

HYPOTHESES DEVELOPMENT

Academic literature presents two conflicting views on the relationship between corporate governance and audit fees. Tsui, Jaggi and Gul (2001), and Yatim, Kent and Clarkson (2006) argue that better corporate governance reduces control and inherent risk, and thus will reduce audit effort. This argument can be described as a 'supply-side' theory. Yatim et al. (2006), in accordance with agency theory, argue that boards that are independent from management provide the most effective monitoring and controlling of firm activities and most effectively reduce opportunistic managerial behaviour and the expropriation of firm resources. Knechel and Willekens (2006), consistent with a 'supply-side' perspective, claim that good corporate governance should improve the overall control environment and reduce the need for extensive external audit effort, thus leading to a reduction in audit fees.

This 'supply-side' theory is further supported by Adams, Sherris and Hossain (1997) who argue that firms' audit fees will be (at least partially) determined by the monitoring costs of the auditor, which in turn reflect the internal governance mechanisms and board structure of the auditee. Audit fees are an important part of these monitoring costs because auditors are obligated to inspect accounts and to ensure that managers behave according to shareholder interests (Nikkinen & Sahlstrom, 2004). Bliss, Muniandy and Majid (2007) argue that the presence of independent directors and an audit committee reduces the inherent risk caused by CEO duality in Malaysia.

Specifically, a stronger control and governance environment is likely to reduce the auditor's assessment of control risk and the extent of audit procedures, thus reducing audit fees. These supply-side arguments would lead, in the absence of strong 'demand-side' effects, to the prediction of a *negative* relationship between corporate governance and audit fees.

Hay, Knechel and Ling (2008) suggest, though, that a 'demand-side' effect may result in a *positive* relationship between corporate governance and audit fees. They argue that audit demand is a function of the set of risks faced by an organisation's individual stakeholders and the set of control mechanisms available for mitigating these risks. Because individual decisions about control processes and procedures may shift benefits and costs across groups of stakeholders, the net investment in auditing may increase when multiple

stakeholders become involved in corporate governance decisions. For instance, the audit cost is more likely to be borne by equity shareholders who may have little say in determining the extent of audit work undertaken (Carcello, Hermanson, Neal, & Riley, 2002; Hay et al., 2008). Hay et al. (2008) explain that while the presence of a major shareholder in a firm could result in higher audit fees, an increase in audit fees could also result from the demand by minority shareholders for more audit effort as a protection against exploitation from the major shareholder.

Similarly, Carcello et al. (2002), Abbott, Parker, Peters and Raghunandan (2003), Fan and Wong (2005), and Goodwin-Stewart and Kent (2006) argue that the demand for stronger corporate governance induces the auditee to seek out better auditing and internal control. In other words, because good governance is valued by the firm's stakeholders, it chooses to purchase higher quality audit services and thus is charged higher audit fees. For example, Mitra et al. (2007) argue that high agency costs might result in better corporate governance. Under these circumstances, stakeholders will demand a better audit.

O'Sullivan (2000), Carcello et al. (2002), and Salleh, Stewart and Manson (2006) argue on the basis of board independence. They argue that if the board has a high level of independence—as suggested by the number of independent non-executive directors either on the board of directors or on other boards (e.g., remuneration, nomination and audit committees)—it will demand more audit effort. Carcello et al. (2002) further argue that the higher demand for audit effort results from directors seeking liability protection by protecting their reputation as monitors. Furthermore, independent directors tend not to have psychological ties with companies because, unlike executive directors, they are not financially dependent upon the company. As such, these directors should be more willing to question management's decisions and arguably reduce bias in the reporting of the entity's financial results (Beasley et al., 2000).

O'Sullivan (2000) argues that non-executive directors are expected to favour more extensive auditing to complement their own monitoring responsibilities. Similarly, Abbott et al. (2003) contend that an audit committee could expand the audit's scope to avoid being associated with financial misstatements. These 'demand-side' theories all clearly suggest a positive relationship between corporate governance and audit fees. We contend that the demand-side arguments are theoretically stronger and more convincing than the supply-side arguments. Furthermore, previous research results provide stronger support for a positive relationship. These conclusions support the theory that demand-side effects dominate supply-side effects. Therefore, we posit the following hypothesis (in alternate form):

H_1: There is a positive relationship between the level of corporate governance and audit fees.

Examining the effects of numerous corporate governance variables on audit fees yields contrasting results. Carcello et al. (2002), O'Sullivan (2000), and Salleh et al. (2006) find that various board characteristics positively affect audit fees. In contrast, Tsui et al. (2001) find that corporate governance provides a better control and governance environment and leads to lower audit fees.

In 2001, Malaysia experienced a corporate governance reform whereby the MCCG became a part of the KLSE Listing Requirements. Part (3), Paragraph IV of the MCCG states: "The external auditors should independently report to shareholders in accordance with statutory and professional requirements and independently assure the board on the discharge of its responsibility." Part (4) of the MCCG further explains that the role of external auditors is to ensure that the firm presents a balanced and understandable assessment of the firm's position (Part 4, Section D, Para 4.13) and maintains sound internal control (Part 4, Section D, Para. 4.14).

Extant academic literature frequently models audit fees as a function of the application of audit efforts and the extent of the auditor's legal liability (Simunic, 1980). Because of the MCCG's Part 1 requirements and other statutory requirements that demand an increase in audit effort, a growing consensus emerges that audit fees are expected to increase following the introduction of the MCCG (Griffin & Lont, 2007; Mohd Salman & Carson, 2009). We next will discuss how we expect the association between corporate governance and audit fees to systematically alter post-MCCG. Griffin and Lont (2007), and Ghosh and Pawlewicz (2008) find that audit fees in the United States increased following the enactment of the Sarbanes-Oxley Act in 2002. On the basis of the arguments presented above, we predict the following hypothesis (in alternate form):

H_2: There is a positive relationship between the introduction of the MCCG and audit fees.

We also examine the *joint impact* of corporate governance and reform on audit fees because corporate governance forms an integral part of the MCCG. Past studies (Abdul Wahab, How, & Verhoeven, 2007; Kouwenberg, 2006) suggest that the introduction of a corporate governance code improves firms' overall corporate governance structure. According to demand-side logic, the MCCG should raise awareness in the business community of the need for good firm governance. The expectation that the slope will become *more* positive after the reform is based on 'demand-side' arguments. This belief suggests that stakeholders, being more aware after the reform of the need for effective

corporate governance, choose to purchase more audit effort per unit of increase in corporate governance than they previously did. This belief could also indicate that audit firms extract more monopoly rents after the reform by raising audit fees, independently of audit effort, at a higher rate per unit increase in corporate governance. Either or both of these effects could be occurring. This leads to the following hypothesis H_3 (in alternate form):

> H_3: The positive relationship between the level of corporate governance and audit fees is stronger after the introduction of MCCG.

DATA AND RESEARCH METHODS

The panel data set (unbalanced) includes 379 non-financial firms for four years from 1999 to 2002. The chosen time period allows for a two-year period before and after the 2001 MCCG. Data for corporate governance variables are hand collected from annual reports, which are available from Bursa Malaysia (www.bursamalaysia.com) and Mergent Online databases. Consistent with other audit studies, we exclude from our sample financial firms and firms with negative equity. Meanwhile, the audit fees data are collected from two sources: Compustat Global and annual reports. The remaining data are collected from Mergent Online, Compustat Global and DataStream databases and Stock Performance Guide. This study uses period seemingly unrelated regressions (SUR) to handle both heterocedasticity and contemporaneous correlations in each cross-section. We posit the following audit fees model (showing the experimental variables in bold type):

$$\begin{aligned} LAF_{it} = {} & a_0 INTERCEPT_{it} + a_1 \mathbf{CGOV}_{it} + \mathbf{a_2 REFORM}_{it} + \\ & \mathbf{a_3 CGOV*REFORM}_{it} + a_4 LNASSETS_{it} + \\ & a_5 INSTOWN_{it} + a_6 LNSUBS_{it} + a_7 LNFOREIGN_{it} + \\ & a_8 CURRENT_{it} + a_9 LIQUID_{it} + a_{10} DEBT_{it} + a_{11} ROA_{it} + \\ & a_{12} LOSS_{it} + a_{13} INDUSTRY_{it} + a_{14} AUDIT_{it} + \\ & a_{15} POLITIC_{it} + e_{it} \end{aligned}$$

Dependent Variable

Because most audit fees models use the logarithmic transformation of audit fees as the dependent variable, the tests in this study are conducted using logarithmic transformation as the dependent variable (*LAF*). We use audit fees because we are interested in knowing the extent of auditor investigation. It is reasonable to assume that more investigation will require more audit hours and/or the use of a more specialised audit staff, resulting in higher audit fees (O'Sullivan, 2000).

Furthermore, the use of audit fees as a proxy for audit quality would be appropriate because audit quality is unobservable (O'Sullivan, 2000). The auditor or the auditee can initiate more (or less) audit effort and higher (or lower) fees.

Experimental Variables

The corporate governance index (*CGOV*), obtained from Abdul Wahab et al. (2007), is constructed using Part 2 and Part 4 of the MCCG's new disclosure rules and consists of 30 governance-related variables. The first part (*MCCG_PT2*) relates primarily to compliance with the governance practices enumerated in the MCCG's Part 2, *Best practices*. The second part (*MCCG_PT4*) relates to disclosures of the governance practices recommended in the MCCG's Part 4, *Explanatory notes*. To find the impact of the 2001 corporate governance reform, we also construct a dummy variable (*REFORM*) that takes a value of 'one' for the post-2001 period and a value of 'zero' otherwise. We also create an interaction variable (*CGOV*REFORM*) to discover the *incremental* impact of corporate governance on audit fees as a result of the MCCG's passage.

Control Variables

Because the natural log transformation of total assets (*LNASSETS*) is generally regarded as an important determinant for variation of audit fees (Hay, Knechel, & Wang, 2006), we allow it to proxy for firm size. We posit a positive relationship between firm size and audit fees. Larger firms are more complex which requires more audit effort and results in higher audit fees (Simunic, 1980; Francis, 1984). We control for ownership structure by incorporating institutional ownership (*INSTOWN*). We argue that the presence in firms of institutional investors increases the level of monitoring (Brickley, Lease, & Clifford, 1988; Cornett, Marcus, Saunders, & Tehranian, 2007) and that these firms require more audit effort from the auditors. As such, we posit a positive relationship between institutional ownership and audit fees (Kane & Velury, 2004). Equally important, we account for the natural log transformation of total subsidiaries (*LNSUBS*) and foreign subsidiaries (*LNFOREIGN*) to control further for audit complexity (Simunic, 1980; Hackenbrack & Knechel, 1997).

We also include the ratio of current assets to total assets (*CURRENT*) to control for inherent risk. We predict a positive relationship between *CURRENT* and audit fees because certain parts of the audit may have a higher risk of error and require specialised audit procedures (Simunic, 1980). Liquidity is controlled for by including the working capital ratio, represented by the ratio of current assets to current liabilities (*LIQUID*). Furthermore, we include the debt ratio, represented by the ratio of total debt to total equity (*DEBT*).

We include return on assets (*ROA*) as a proxy for profitability. We predict a negative relationship between *ROA* and audit fees. Firms with a low *ROA* require more audit effort, and auditor liability is a more pressing concern in such cases. In addition, we include a dummy for firms that recorded a loss (*LOSS*) in the year preceding the prediction of a positive relationship.

Finally, industry dummies that take a value of 'one' for firms belonging to the construction (*CONSTRUCTION*), consumer (*CONSUMER*), high technology (*TECHNOLOGY*), and other (*OTHER*) sectors and take a value of 'zero' otherwise are included to control for variations in audit fees across industries. Conventional wisdom demonstrates that some industries are more difficult and more labour-intensive to audit (Simunic, 1980; Turpen, 1990; Pearson & Tormpeter, 1994). We include a dummy variable for Big 'n' auditing firms (*AUDIT*) to control for differences in audit quality. We assume that auditees associated with large auditing firms purchase the highest quality audits (Carcello et al., 2002).

We extend the analysis by including political connection, an attribute that is unique to Malaysia (Gul, 2006). Gul provides empirical evidence to support the proposition that auditors perceive greater inherent risk in politically connected firms. This perception leads to greater audit effort, and greater audit effort leads to higher fees. Gul suggests that this greater inherent risk exists because these firms have a higher probability of their business failing and because they are more likely to misstate their financial health in their financial statements to avoid covenant violations. Gul documents evidence of *crony-capitalism* in Malaysia by demonstrating that there was a comparatively greater increase in audit fees for politically connected firms following the Asian Financial Crisis and that the audit fees for firms declined following the government's introduction of capital controls to help its preferred firms. On the basis of the arguments presented above, we posit a positive relationship between politically connected firms (*POLITIC*) and audit fees. We derive our list of political connections from the following sources: Johnson and Mitton (2003), Mohamad, Hassan and Chen (2006), and the Khazanah Nasional Berhad website (www.khazanah.com.my).

Table 1
Definition and expected direction of variables

No.	Variables	Sign	Definition	Source
1	*LAF*		Natural logarithm of audit fees.	Annual reports and Compustat Global.
Panel A: Experimental Variables				
2	*CGOV*	+	Corporate Governance	Abdul Wahab et al. (2007)
3	*REFORM*	+	An indicator variable, 1 for years 2001 and 2002.	–
4	*CGOV*REFORM*	–	An interaction variable between corporate governance and the reform period.	–
Panel B: Client Attributes				
5	*LNASSETS*	+	Natural logarithm of total assets.	DataStream, Compustat Global and Stock Performance Guide.
6	*INSTOWN*	+	Top five institutional shareholdings in each firm.	Annual reports.
7	*LNSUBS*	+	Natural logarithm of number of subsidiaries.	Mergent Online and Annual Reports.
8	*LNFOREIGN*	+	Natural logarithm of number of foreign subsidiaries.	Mergent Online and Annual Reports.
9	*CURRENT*	+	Current assets to total assets.	DataStream, Compustat Global and Stock Performance Guide.
10	*ROA*	–	Net profit before tax over total assets.	DataStream, Compustat Global and Stock Performance Guide.
11	*LOSS*	+	An indicator variable, 1 for loss in the last year.	DataStream, Compustat Global and Stock Performance Guide.
12	*LIQUID*	–	Current assets to current liabilities.	DataStream, Compustat Global and Stock Performance Guide.
13	*DEBT*	+	Total debt to total equity.	DataStream, Compustat Global and Stock Performance Guide.

(*continued*)

Table 1 (*continued*)

No.	Variables	Sign	Definition	Source
14	*INDUSTRY*	?	Industry dummies that take a value of one for firms belonging to the construction (*CONSTRUCTION*), consumer (*CONSUMER*), high technology (*TECHNOLOGY*) and other (*OTHER*) sectors and zero otherwise.	Bursa Malaysia's website.
Panel C: Auditor Attribute				
15	*AUDIT*	+	An indicator variable, 1 for Big 'n' audit firms.	Annual reports and Compustat Global.
Panel D: Country Attributes				
16	*POLITIC*	+	An indicator variable, 1 for politically-connected firms.	Johnson and Mitton (2003), Mohamad et al. (2006) and Khazanah Berhad website (www.khazanah.gov.my).

Descriptive Statistics

Table 2 presents the descriptive statistics for this study. Ringgit Malaysia (RM) 275,700 (RM110,000) with a range between RM500 and RM9.4 million represents the average (median) audit fees for the sample firms. The main measure for corporate governance (*CGINDEX)* records a mean (median) of 37.690 (36.607) with a maximum score of 79.911. M*CCG_PT2* and *MCCG_PT4* record respective means (medians) of 41.859 (31.250) and 33.520 (35.714). Our list shows that 20.9% of the sample firms are politically connected. The mean (median) for total assets (*ASSETS*) is RM1.876 billion (RM608.6 million), while the top five institutional investors' shareholdings (*INSTOWN*) average 12.100%. The number of subsidiaries (*SUBS*) averages 29.000 with a range between 0 and 407 subsidiaries, while firms average 6.700 foreign subsidiaries (*FOREIGN*). The mean (median) for *CURRENT* is 0.347 (0.251), while the mean (median) for *ROA* is 5.836% (5.267%). For the past fiscal year, 18.4% of the sample firms recorded a loss. *LIQUID* and *DEBT* average 3.648 and 1.773, respectively.

Table 2
Descriptive statistics for sample firms (1999–2002)

	Mean	Median	Maximum	Minimum	Std. Dev.
AF('000)	275.70	110.00	9400.00	0.500	664.60
LAF	11.733	11.617	16.056	8.517	1.121
Experimental Variables					
CGINDEX	37.690	36.607	79.911	0.000	18.310
MCCG_PT2	41.859	31.250	87.500	0.000	19.617
MCCG_PT4	33.520	35.714	78.571	0.000	19.133
ASSETS ('000)	1,876,000	608,600	61,770,000	465.10	4,975,000
LNASSETS	20.387	20.227	24.847	15.353	1.273
INSTOWN	12.100	5.830	90.553	0.000	16.944
CURRENT	0.347	0.343	1.000	0.000	0.205
LIQUID	3.648	1.596	195.090	–59.982	12.534
SUBS	29.000	15.000	407.000	0.000	43.977
LNSUBS	1.313	2.708	6.009	–11.513	4.584
FOREIGN	6.700	2.000	224.000	0.000	17.577
LNFOREIGN	–3.304	0.693	5.412	–11.513	6.390
DEBT	1.773	0.517	37.463	0.000	3.798
ROA	5.836	5.267	140.162	–88.504	11.776
LOSS	0.173	0.000	1.000	0.000	0.378
AUDIT	0.703	1.000	1.000	0.000	0.457
POLITIC	0.209	0.000	1.000	0.000	0.407

Note: Observations having a zero for *LNSUBS* or for *LNFOREIGN* are re-coded to a small positive (0.0001) to enable a logarithmic transformation.

AF is audit fees while *LAF* is natural logarithm of audit fees. *CGINDEX* is a composite measure of the MCCG. *MCCG_PT2* is a composite measure of corporate governance based on Part 2 of the MCCG, which requires firms to explain and provide alternative practices adopted when departing from best practices. *MCCG_PT4* is a composite measure of corporate governance based on Part 4 of the MCCG, which provides explanatory notes to the principles and best practices. *ASSETS* is total assets while *LNASSETS* is natural log transformation of *ASSETS*. *INSTOWN* is the percentage shareholdings by top five institutional investors. *CURRENT* is current assets to total assets. *LIQUID* is current assets to current liabilities. *SUBS* is the number of subsidiaries while *LNSUBS* is the natural log transformation of *SUBS*. *FOREIGN* presents the number of foreign-domicile subsidiaries and *LNFOREIGN* is the natural log transformation of *FOREIGN*. *DEBT* is total debt over total equity. *ROA* is earnings divided by total

assets. *LOSS* takes the value of 1 if the firm recorded a loss in the previous fiscal year. *AUDIT* takes the value of 1 for Big 'n' auditors and zero otherwise. *POLITIC* takes the value of 1 for politically-connected firms and zero otherwise.

RESULTS

Univariate Analysis

Table 3 reports the correlations between the variables during the test period. Furthermore, Table 4 reports the differences in the means and medians for the test variables between the pre- and post-test period. Because the univariate analyses include both continuous and dichotomous variables, both *t*-tests and chi-square tests are used (as appropriate) to test for differences. We observe no significant difference in audit fees (*LAF*) before and after the corporate governance reforms. As expected, the sample firms' various measures of corporate governance (*CGOV*) record significantly higher scores for the 2001–2002 period. Corporate governance generally improves after 2001, but we cannot conclusively determine the extent to which the MCCG affected this improvement. Corporate governance improvement is partially demand driven. Individual firms respond to greater demand for corporate governance on the part of their stakeholders. Before the reforms, the sample firms had significantly bigger size (*ASSETS*) and a higher return on assets (*ROA*).

Pearson (in shaded) and Spearman Rank correlations are reported in the table. *LAF* is natural logarithm of audit fees. *CGINDEX* is a composite measure of the Malaysian Code on Corporate Governance (MCCG). *POLITIC* takes the value of 1 for politically-connected firms and zero otherwise. *ASSETS* is total assets. *INSTOWN* is the percentage shareholdings by top five institutional investors. *LNSUBS* is the natural log transformation of subsidiaries while *LNFOREIGN* presents the natural log transformation of foreign-domicile subsidiaries. *CURRENT* is current assets to total assets. *ROA* is earnings divided by total assets. *LOSS* takes the value of 1 if the firm recorded a loss in the previous fiscal year. *LIQUID* is current assets to current liabilities. *DEBT* is total debt over total equity. *AUDIT* takes the value of 1 for Big 'n' auditors and zero otherwise. *, ** and *** denote significance level at 10%, 5% and 1% respectively.

Table 3
Correlations for sample firms (1999–2002)

	LAF	*CGINDEX*	*ASSETS*	*INSTOWN*	*CURRENT*	*LIQUID*	*LNSUBS*	*LNFOREIGN*	*DEBT*	*AUDIT*	*ROA*	*LOSS*	*POLITIC*
LAF	1.000	0.076**	0.569***	0.206***	–0.027	–0.163***	0.580***	0.502***	–0.052*	0.026	0.015	–0.026	0.250***
CGINDEX	*0.084****	1.000	–0.030	0.032	–0.004	0.045	0.021	–0.048*	–0.075**	–0.040	–0.075**	0.003	–0.045
ASSETS	*0.588****	*–0.022*	1.000	0.198***	–0.238***	–0.154***	0.500***	0.418***	–0.105***	0.037	0.009	–0.073**	0.327***
INSTOWN	*0.249****	*0.056**	*0.226****	*1.000*	0.004	0.055*	0.111***	0.104***	–0.079***	0.104***	0.047	–0.066**	0.040
CURRENT	*–0.061***	*–0.002*	*–0.260****	*–0.027*	1.000	0.457***	–0.027	0.040	–0.086***	0.002	0.126***	–0.064**	–0.031
LIQUID	*–0.220****	*–0.012*	*–0.148****	*–0.013*	*0.333****	1.000	–0.118***	–0.093***	–0.287***	0.022	0.242***	–0.193***	–0.106***
LNSUBS	*0.314****	*0.041*	*0.283****	*0.071***	*–0.053**	*–0.070***	1.000	0.769***	–0.043	–0.052*	–0.096***	–0.025	0.171***
LNFOREIGN	*0.396****	*–0.034*	*0.317****	*0.023*	*–0.017*	*–0.130****	*0.552****	1.000	–0.006	–0.046	–0.062*	–0.011	0.215***
DEBT	*–0.104****	*–0.036*	*–0.103****	*–0.069***	*0.033*	*0.021*	*–0.128****	*0.004*	1.000	–0.016	–0.148***	0.121***	0.016
AUDIT	*0.041*	*–0.046*	*0.036*	*0.111****	*0.001*	*0.026*	*0.016*	*–0.033*	*–0.018*	1.000	0.011	0.032	0.098***
ROA	*0.011*	*–0.078****	*0.008*	*–0.012*	*0.065***	*–0.025*	*–0.083****	*–0.052**	*–0.034*	*0.011*	1.000	–0.383***	–0.094***
LOSS	*–0.027*	*0.003*	*–0.072****	*–0.028*	*–0.052**	*0.067***	*0.011*	*0.001*	*0.051**	*0.032*	*–0.288****	1.000	0.107***
POLITIC	*0.301****	*–0.049**	*0.376****	*0.139****	*–0.016*	*–0.010*	*0.114****	*0.174****	*–0.018*	*0.098****	*–0.075***	*0.107****	*1.000*

Table 4
Univariate analysis of differences in audit fees, corporate governance and firm characteristics in the pre- and post-MCCG period

	1999–2000 (n = 599)			2001–2002 (n = 741)			t-test	Mann Whitney
	Mean	Med	Std. Dev.	Mean	Med	Std. Dev.	P-value	P-value
AF	269.20	106.00	666.60	280.90	112.00	663.40	0.749	0.395
LAF	11.699	11.571	1.091	11.756	11.644	1.141	0.383	0.369
Experimental Variables								
CGINDEX	20.034	19.643	6.632	50.676	53.125	12.303	**0.000**	**0.000**
MCCG_PT2	25.677	25.000	7.806	53.762	56.250	16.992	**0.000**	**0.000**
MCCG_PT4	14.391	14.286	8.917	47.590	50.000	10.462	**0.000**	**0.000**
Client Attributes								
ASSETS	2006000	660100	4880000	1771000	554800	5051000	**0.390**	**0.012**
LNASSETS	20.491	20.308	1.264	20.304	20.134	1.274	**0.008**	**0.011**
OWNINST	12.374	5.817	17.365	11.897	5.881	16.634	0.618	0.911
CURRENT	0.346	0.337	0.212	0.347	0.345	0.200	0.941	0.598
LIQUID	3.392	1.555	12.971	3.843	1.616	12.198	0.524	0.177
SUBS	29.593	15.000	45.381	28.521	15.000	42.833	0.658	0.494
LNSUBS	1.129	2.708	4.810	1.461	2.708	4.390	0.188	0.494
FOREIGN	7.228	2.000	18.258	6.273	1.000	17.008	0.328	0.146
LNFOREIGN	-3.089	0.693	6.374	–3.478	0.000	6.401	0.269	0.146
DEBT	1.752	0.541	3.410	1.790	0.483	4.087	0.855	0.066
ROA	6.950	5.597	12.187	4.936	4.935	11.361	**0.002**	**0.015**
LOSS	0.192	0.000	0.394	0.158	0.000	0.365	(0.110)	0.107
Auditor Attribute								
AUDIT	0.722	1.000	0.448	0.689	1.000	0.463	(0.199)	0.201
Country Attribute								
POLITIC	0.230	0.000	0.421	0.192	0.000	0.394	**(0.085)**	**0.083**

Note: Observations having a zero for *LNSUBS* or for *LNFOREIGN* are re-coded to a small positive (0.0001) to enable a logarithmic transformation.

AF is audit fees while *LAF* is natural logarithm of audit fees. *CGINDEX* is a composite measure of the Malaysian Code on Corporate Governance (MCCG). *MCCG_PT2* is a composite measure of corporate governance based on Part 2 of the MCCG, which requires firms to explain and provide alternative practices adopted when departing from best practices. *MCCG_PT4* is a composite measure of corporate governance based on Part 4 of the MCCG, which provides explanatory notes to the principles and best practices. *ASSETS* is total assets while *LNASSETS* is natural log transformation of *ASSETS*. *INSTOWN* is the percentage shareholdings by top five institutional investors. *SUBS* is the number of subsidiaries while *LNSUBS* is the natural log transformation of *SUBS*. *FOREIGN* presents the number of foreign-domicile subsidiaries and *LNFOREIGN* is the natural log transformation of *FOREIGN*. *CURRENT* is current assets to total assets. *ROA* is earnings divided by total assets. *LOSS* takes the value of 1 if the firm recorded a loss in the previous fiscal year. *LIQUID* is current assets to current liabilities. *DEBT* is total debt over total equity. *AUDIT* takes the value of 1 for Big 'n' auditors and zero otherwise. *POLITIC* takes the value of 1 for politically-connected firms and zero otherwise. Significant *p*-values are in bolds. The figures in parentheses denote Chi-square statistics.

Multivariate Analysis

Table 5 shows the panel least squares results. Column 1 presents our tabulated result for the basic audit fees model (calculated using all variables less experimental variables). These calculations indicate that the variables are as predicted and significant with the exception of several client attribute variables. We observe positive and significant intercepts or constant terms across all model specifications, which indicate fixed costs in setting up and conducting an audit, regardless of the attributes captured by other variables (Pong & Whittington, 1994).

As expected, we find natural logarithm of audit fees (*LAF*) to be positively and significantly related to firm size (*LNASSETS*), institutional ownership (*INSTOWN*), and a factor of audit complexity (*LNFOREIGN*). We find evidence to support the proposition that the ratio of current assets to total assets (*CURRENT*) is associated with the variation in audit fees. Finally, our basic audit fees model shows no relationship between the auditor's attribute (*AUDIT*) and audit fees. Our adjusted *R*-square for the basic model is 63.5%.

We extend the basic audit fees model by including the experimental variables as presented in Columns 2 through 6 of Table 5. Hypothesis 1 predicts a positive relationship between corporate governance and audit fees. As predicted, we find that the coefficient for our main measure of corporate governance (*CGINDEX*) is positive and significant (0.017, $t = 2.934$, $p < 0.01$), thus

indicating that, on average, better overall corporate governance is associated with stakeholders also demanding more audit effort. This demand ultimately increases audit fees. The result supports a 'demand-side' argument.

Hypothesis 2 expects a positive relationship between the introduction of the MCCG and audit fees. Our results confirm our expectation; the coefficient for (REFORM) is positive and significant (0.307, $t = 2.934$, $p < 0.01$). The results suggest that the Bursa Listing requirements and the introduction of the MCCG have instigated greater audit effort and thus have increased the audit fees being paid to external auditors.

The interaction variable (*CGOV*REFORM*) examining the impact of corporate governance during the 2001–2002 period has a negative and significant coefficient here (–0.013, $t = -2.146$, $p < 0.05$). Because the *CGINDEX* variable has a positive effect on audit fees, the negative coefficient for the interaction variable suggests a *less positive* relationship between corporate governance and audit fees after the enactment of the MCCG in 2001. This result contradicts our prior expectations, which were based exclusively on demand-side arguments.

Our interaction results suggest that the MCCG has lowered auditors' overall assessments of inherent and control risks for Malaysian firms and has led to reduced audit effort. Post-reform analysis shows a smaller increase in audit effort and audit fees for every unit increase in corporate governance. Thus, a supply-side effect is operating after the reform. These effects exist in addition to the demand-side effects confirmed by our empirical testing of the demand-based hypotheses H_1 and H_2. The MCCG seems to be an effective economy-wide signalling mechanism; auditors are more willing to rely on corporate governance improvements after the governance reform. This reliance on corporate governance in turn reduces external audit effort. Our result is similar to Goddard and Masters' (2000) examination of the Cadbury Codes, who find a reduction in audit fees after the implementation of the code because of increased assessment of internal controls. Although this result suggests that better corporate governance provides better control and reduces risk (Yatim et al., 2006), the audit discount is only 1.29%. In other words, the economic impact on reduction of audit fees is minimal. The remaining interaction variables, with the exception of *MCCG_PT4* and *QUANTITY*, also have negative and significant coefficients. The remaining control variables remain similar to Column 1 of Table 5, further supporting the robustness of the initial audit fees model.

Table 5
Panel least squares estimation of audit fees (1999–2002)

	Expected direction	*LAF* 1	*LAF* 2	*LAF* 3	*LAF* 4
INTERCEPT	+	3.446	2.974	2.855	3.221
		4.620*	***3.958****	***3.800****	***4.293****
Experimental Variables					
CGINDEX	+		0.017		
			2.934*		
MCCG_PT2	+			0.016	
				3.242*	
MCCG_PT4	+				0.006
					1.487
REFORM	+		0.307	0.444	0.087
			1.730*	***2.764****	*0.500*
CGINDEX(REFORM)*	-		–0.013		
			–2.146*		
MCCG_PT2(REFORM)*	-			–0.014	
				–2.680*	
MCCG_PT4(REFORM)*	-				–0.003
					–0.542
LNASSETS	+	0.411	0.411	0.414	0.411
		11.888*	***11.948****	***12.036****	***11.889****
INSTOWN	+	0.008	0.008	0.008	0.008
		3.642*	***3.343****	***3.481****	***3.460****
CURRENT	+	0.751	0.739	0.735	0.745
		3.972*	***3.935****	***3.916****	***3.949****
LIQUID	+	–0.016	–0.016	–0.016	–0.016
		–5.332*	***–5.248****	***–5.232****	***–5.349****
LNSUBS	+	0.014	0.013	0.012	0.013
		1.465	*1.298*	*1.242*	*1.351*
LNFOREIGN	+	0.031	0.033	0.032	0.033
		4.340*	***4.554****	***4.524****	***4.517****

(*continued*)

Table 5 (*continued*)

	Expected direction	*LAF*	*LAF*	*LAF*	*LAF*
		1	2	3	4
DEBT	+	–0.013	–0.012	–0.012	–0.012
		–1.694*	*–1.511*	*–1.590*	*–1.574*
ROA	–	0.002	0.003	0.003	0.003
		0.845	*1.133*	*1.142*	*1.160*
LOSS	+	0.084	0.089	0.091	0.092
		1.110	*1.188*	*1.214*	*1.215*
AUDIT	+	0.038	0.046	0.050	0.045
		0.475	*0.574*	*0.625*	*0.560*
POLITIC	+	0.158	0.173	0.172	0.165
		1.553	***1.704****	***1.697****	*1.627*
Industry fixed	?	Yes	Yes	Yes	Yes
Adjusted R-squared		63.5	65.5	65.3	67.3
F-statistic		***72.549****	***61.649****	***61.884****	***60.850****
Cross-sections		379	379	379	379
Total observations		1182	1182	1182	1182

Country attribute

Country attribute results reported in Table 5 reveal that the politically connected firms' (*POLITIC*) coefficient is positive and significant. This result is consistent with Gul's (2006) suggestion that politically connected firms present more audit risk, and it supports demand-based arguments. Stakeholders, being aware of a firm's political connections, seem willing and able to pay higher audit fees for such auditees so that more audit effort can be applied. Stakeholders seem very 'aware' of political connections and use the external audit mechanism to partially compensate for the negative effects of political connection. Audit fees may be higher, though, independently of audit effort because political connections allow for wealth transfers between the auditee and the auditor. Under this interpretation, Big 'n' firms opportunistically 'trade on' political connections when they operate in Malaysia by extracting a higher fee from the politically connected firms. 'Crony capitalism' would, according to this explanation, also extend to the Big 'n' auditors' Malaysian operations. The parameter of 0.173 (Column 2) for *POLITIC* suggests an audit fees premium of 18.86%.

LAF is natural logarithm of audit fees. *CGINDEX* is a composite measure of the Malaysian Code on Corporate Governance (MCCG). *MCCG_PT2* is a

composite measure of corporate governance based on Part 2 of the MCCG, which requires firms to explain and provide alternative practices adopted when departing from best practices. *MCCG_PT4* is a composite measure of corporate governance based on Part 4 of the MCCG, which provides explanatory notes to the principles and best practices. *LNASSETS* is natural log transformation of total assets. *INSTOWN* is the percentage shareholdings by top five institutional investors. *CURRENT* is current assets to total assets. *LIQUID* is current assets to current liabilities. *LNSUBS* is the log transformation of number of subsidiaries while *LNFOREIGN* presents the log transformation of number of foreign-domicile subsidiaries. *DEBT* is total debt over total equity. *ROA* is earnings divided by total assets. *LOSS* takes the value of 1 if the firm recorded a loss in the previous fiscal year. *AUDIT* takes the value of 1 for Big 'n' auditors and zero otherwise. *POLITIC* takes the value of 1 for politically-connected firms and zero otherwise. t-statistics are italicised. *, ** and *** denote significance level at 10%, 5% and 1% respectively.

CONCLUSION

The results of previous research examining the relationship between corporate governance and audit fees have been inconclusive and conflicting. Our initial finding suggests that audit fees are positively and significantly related to corporate governance. However, we find a *less positive* relationship between corporate governance and audit fees after 2001, on the basis of the interaction of post-MCCG dummy and corporate governance. This finding suggests, consistent with 'supply-side' explanations, that the MCCG, in combination with actual corporate governance changes by firms, reduces the perception of risk and enhances firms' control. These shifts ultimately reduce audit effort. Our study is consistent with Goddard and Masters' (2000) examination of the impact of the Cadbury Code on audit fees. Further, our findings remain the same after controlling for political connections that could impact the price of audit services.

The present study has a number of limitations that provide opportunities for further research. First, similarly to the caveat given in Gul (2006), our study acknowledges that our list of politically connected firms depends on Johnson and Mitton (2003). Further research should measure political connection variables using a different method. Sociological research on Malaysia may lead to a more informed and nuanced measurement of political connection. In addition, this study only focuses on political connection as a country-specific attribute. Other proxies such as ethnicity and family companies may be more suitable as attributes for the Malaysian environment.

Future research should examine extensively the nature of *CGOV* factors and their relation to audit fees. Examples of *CGOV* factors include the activities carried out by audit committees and directors' relationships with major shareholders. Furthermore, a longitudinal study, expanding more than five years before and after the introduction of the MCCG, would be beneficial in measuring the long term impact of governance on audit fees.

ACKNOWLEDGEMENT

We would like to say thank you to Ferdinand Gul, David Hay, Julie Cotter, Jenny Stewart, Reza Monem, Fauziah Md. Taib, Yusserie Zainuddin, two anonymous reviewers and seminar participants at University of Southern Queensland and Griffith University for their helpful comments. Capable research assistance from Wan Adibah Wan Adnan and Suhaily Hasnan is very much appreciated.

NOTES

1. The main purpose of the joint KLSE/Price Waterhouse Corporate Governance survey was to improve the corporate governance framework and ensure companies conduct their businesses with the highest possible standard of 'best practices'.
2. Examples of studies include Abdul Wahab et al. (2007) for Malaysia; McKnight, Milonas, Tcarlos and Weir (2005) for the United Kingdom; Aggarwal and Williamson (2006) for the United States; and Kouwenberg (2006) for Thailand.
3. A review of literature indicates that a number of studies examine the relationships between corporate governance, ethnicity, political connection and audit fees of the listed Malaysian firms (Yatim et al., 2006; Gul, 2006; Abdul Wahab, Mat Zain, James, & Haron, 2009). However, most of these studies assess the corporate governance impact on audit fees using an individual corporate governance measure rather than a composite corporate governance index.
4. Apart from corporate governance, institutional investors and auditors' responsibility are mentioned in Part 3 of the MCCG.
5. The seemingly unrelated regression (SUR) method—also known as the multivariate regression, or Zellner's method—estimates the parameters of the system, accounting for heteroskedasticity and contemporaneous correlation in the errors across equations. The estimates of the cross-equation covariance matrix are based on parameter estimates of the unweighted system.
6. Please see Appendix A for a detailed explanation of the construction of CGINDEX.
7. We have based our choice of variables on the work of Hay et al. (2006). We would like to thank an anonymous reviewer for this suggestion.
8. Regression results are reported without the industry dummies. The results that include the industry dummies can be obtained from the corresponding author.
9. The Big 'n' audit firms are Arthur Andersen, Deloitte, KPMG, Ernst and Young, and PricewaterhouseCoopers. For the sake of consistency, well-known partner firms

(e.g., Kassim Chan and Hanafiah Raslan) to the Big 'n' are classified as Big auditors if they are mentioned explicitly. Transitional audit firms during the Arthur Andersen saga are not classified as Big 'n' audit firms.

10. Khazanah Nasional Berhad is the Malaysian government's investment holding arm and manages its commercial assets. It was incorporated in September 1993 and began operations in 1994. It is structured as a holding company that is a wholly controlled entity of the Malaysian government's Ministry of Finance (MOF).
11. Our adjusted R-square is comparable to other Malaysian audit studies (e.g., Gul (2006) at 61.6% and Salleh et al. (2006) at 62.5%).
12. Because this is an interaction variable, the interpretation of the negative coefficient must consider the other 'stand-alone' variables (CGINDEX and REFORM). The positive slope of *CGINDEX* demonstrates that the inclusion of *REFORM* has weakened the positive slope documented earlier by *CGINDEX*.
13. The audit fee premium or discount is obtained by calculating the effect of the percentage shift on natural log of audit fees and is defined as $e^z - 1$, where z is the parameter for the testable variable. See Craswell et al. (1995) for a thorough explanation.
14. Politically connected firms have a mean *LAF* of 11.991.

REFERENCES

Abbott, L. J., Parker, S., Peters, G. F., & Raghunandan, K. (2003). The association between audit committee characteristics and audit fees. *Auditing: A Journal of Practice and Theory, 22*(2), 17–32.

Abdul Rashid, M. Z., & Ho, J. A. (2003). Perceptions of business ethics in a multicultural community: The case of Malaysia. *Journal of Business Ethics, 43*(1 & 2), 75–87.

Abdul Wahab, E. A., How, J., & Verhoeven, P. (2007). The impact of the Malaysian code on corporate governance: Compliance, institutional investors and stock performance. *Journal of Contemporary Accounting & Economics, 3*(2), 106–129.

Abdul Wahab, E. A., Mat Zain, M., James, K., & Haron, H. (2009). Institutional investors, political connection and audit quality in Malaysia. *Accounting Research Journal, 22*(2), 167–195.

Adams, M., Sherris, M., & Hossain, M. (1997). The determinants of external audit costs in the New Zealand life insurance industry. *Journal of International Financial Management & Accounting*, *8*(1), 69–86.

Aggarwal, R., & Williamson, R. G. (2006). *Did new regulations target the relevant corporate governance attributes?* (Working Paper Series). Washington, D.C.: McDonough School of Business- Georgetown University.

Ali, A., Haniffa, R., & Hudaib, M. (2006). Episodes in the Malaysian auditing saga. *Managerial Auditing Journal, 21*(7), 684–701.

Beasley, M. S., Carcello, J. V., Hermanson, D. R., & Lapides, P. D. (2000). Fraudulent financial reporting: Consideration of industry traits and governance mechanism. *Accounting Horizons, 14*(4), 441–454.

Bebchuk, L., Cohen, A., & Ferrell, A. (2009). What matters in corporate governance? *Review of Financial Studies, 22*(2), 783–827.

Bliss, M., Muniandy, B., & Majid, A. (2007). CEO duality, audit committee effectiveness and audit risks: A study of Malaysian market. *Managerial Auditing Journal, 22*(7), 716–728.

Brickley, J. A., Lease, R. C., & Smith, C. W. (1988). Ownership structure and voting on antitakeover amendments. *Journal of Financial Economics*, *20*, 267–291.

Brown, L. D., & Caylor, M. L. (2006). Corporate governance and firm valuation. *Journal of Accounting and Public Policy*, *25*(4), 409–434.

Carcello, J. V., Hermanson, D. R., L. Neal, T., & A. Riley Jr., R. (2002). Board characteristics and audit fees. *Contemporary Accounting Research*, *19*(3), 365–384.

Cornett, M. M., Marcus, A. J., Saunders, A., & Tehranian, H. (2007). The impact of institutional ownership on corporate operating performance. *Journal of Banking & Finance*, *31*(6), 1771–1794.

Craswell, A. T., Francis, J. R., & Taylor, S. L. (1995). Auditor brand name reputations and industry specializations. *Journal of Accounting and Economics, 20*(3), 297–322.

Durnev, A., & Kim, E. H. (2005). To steal or not to steal: Firm attributes, legal environment, and valuation. *Journal of Finance, 60*(3), 1461–1493.

Eichenseher, J. W., & Shields, D. (1985). Corporate director liability and monitoring preferences. *Journal of Accounting and Public Policy*, *4*, 13–31.

Fan, J. P. H., & Wong, T. J. (2005). Do external auditors perform a corporate governance role in emerging markets? Evidence from East Asia. *Journal of Accounting Research*, *43*(1), 35–72.

Favere-Marchesi, M. (2001). Audit quality in ASEAN. *The International Journal of Accounting*, *35*(1), 121–149.

Finance Committee on Corporate Governance (FCCG). (1999). *Report on corporate governance*. Kuala Lumpur: Ministry of Finance, Malaysia.

Francis, J. R. (1984). The effect of audit firm size on audit prices: A study of the Australian market. *Journal of Accounting and Economics, 6*(2), 133–151.

Ghosh, A., & Pawlewicz, R. (2008). *The impact of regulation on auditor fees: Evidence from the Sarbanes-Oxley Act.* Paper presented at the Joint Symposium of JCAE and APJT, The Hong Kong Polytechnic University, Hong Kong.

Goddard, A., & Masters, C. (2000). Audit committee, Cadbury code and audit fees: An empirical analysis of U.K. companies. *Managerial Auditing Journal, 15*(7), 358–371.

Goodwin-Stewart, J., & Kent, P. (2006). Relation between external audit fees, audit committee characteristics and internal audit. *Accounting and Finance*, *46*, 387–404.

Gomez, E. T., & Jomo, K. S. (1999). *Malaysia's political economy: Politics, patronage and profits*. Cambridge: Cambridge University Press.

Gompers, P. A., Ishii, J. L., & Metrick, A. (2003). Corporate governance and equity prices. *Quarterly Journal of Economics*, *118*(1), 107–155.

Griffin, P. A., & Lont, D. (2007). An analysis of audit fees following the passage of Sarbanes-Oxley. *Asia Pacific Journal Accounting and Economics*, *16*, 161–192.

Gul, F. A. (1999). Audit prices, product differentiation and economic equilibrium. *Auditing: A Journal of Practice and Theory*, *18*(1), 90–100.

Gul, F. A. (2006). Auditors' Response to political connections and cronyism in Malaysia. *Journal of Accounting Research*, *44*(5), 931–963.

Hackenbrack, K., & Knechel, W. R. (1997). Resource allocation decisions in audit engagements. *Contemporary Accounting Research*, *14*(3), 481–499.

Hay, D., Knechel, W. R., & Wong, N. (2006). Audit fees: A meta-analysis of the effect of supply and demand attributes. *Contemporary Accounting Research*, *23*(1), 141–191.

Hay, D., Knechel, W. R., & Ling, H. (2008). Evidence on the impact of internal control and corporate governance on audit fees. *International Journal of Auditing, 12*(1), 9–24.

Johnson, S., & Mitton, T. (2003). Cronyism and capital controls: Evidence from Malaysia. *Journal of Financial Economics*, *67*(2), 351–382.

Kane, G. D., & Velury, U. (2004). The role of institutional ownership in the market for auditing services: An empirical investigation. *Journal of Business Research*, *57*(9), 976–983.

Klapper, L. F., & Love, I. (2004). Corporate governance, investor protection, and performance in emerging markets. *Journal of Corporate Finance, 10*(5), 703–728.

Knechel, W. R., & Willekens, M. (2006). The role of risk management and governance in determining audit demand. *Journal of Business Finance & Accounting, 33*(9 & 10), 1344–1367.

Kouwenberg, R. R. (2006). *Does voluntary corporate governance code adoption increase firm value in emerging markets? Evidence from Thailand*. (Working Paper Series). Thailand: Mahidol University.

Mcknight, P. J., Milonas, N. T., Travlos, N. G., & Weir, C. (2005). *The Cadbury code reforms and corporate performance.* (Working Paper Series). Scotland: University of Saint Andrews.

Mitra, S., Hossain, M., & Deis, D. R. (2007). The empirical relationship between ownership characteristics and audit fees. *Review of Quantitative Finance and Accounting*, *28*, 257–285.

Mohamad, S., Hassan, T., & Chen, C. M. (2006). *Impact of political-business relationship: Ownership patterns and corporate performance in Malaysia*. Paper presented at the 2006 Asian Finance Association Conference, Auckland, New Zealand.

Mohd Ghazali, N., & Weetman, P. (2006). Perpetuating traditional influences: Voluntary disclosure in Malaysia following the economic crisis. *Journal of International Accounting, Auditing and Taxation, 15*(2), 226–248.

Mohd Salman, F., & Carson, E. (2009). The impact of the Sarbanes-Oxley act on Australian listed firms. *International Journal of Auditing, 13*(2), 127–140.

Nikkinen, J., & Sahlstrom, P. (2004). Does agency theory provide a general framework for audit pricing? *International Journal of Auditing*, *8*(3), 253–262.

O'Sullivan, N. (2000). The impact of board composition and ownership on audit quality: Evidence from large U. K. companies. *British Accounting Review*, *32*(4), 397–414.

Ow-Yong, K., & Kooi Guan, C. (2000). Corporate governance codes: A comparison between Malaysia and the U.K. *Corporate Governance: An International Review, 8*(2), 125–132.

Pearson, T., & Trompeter, G. (1994). Competition for market of audit services: The effect of supplier concentration on audit fees. *Contemporary Accounting Research*, *11*(1), 115–135.

Pong, C. M., & Whittington, G. (1994). The determinants of audit fees: Some empirical models. *Journal of Business Finance and Accounting*, *21*(8), 1071–1095.

Salleh, Z., Stewart, J., & Manson, S. (2006). The impact of board composition and ethnicity on audit quality: Evidence from Malaysian companies. *Malaysia Accounting Review*, *5*(2), 61–83.

Simunic, D. (1980). The pricing of audit services: Theory and evidence. *Journal of Accounting Research*, *18*(1), 161–190.

Stock Performance Guide Malaysia. (2003, July). Pulau Pinang: Dynaquest Sdn. Bhd.

Studenmund, A. H. (2001). *Using econometrics: A practical guide* (4th International Ed.). Chicago, IL: Addison Wesley/Longman.

Subramaniam, N., Zain, M. M., & Johl, S. (2009). Corporate governance reforms: Views from Malaysia. In F. J. L. Iturriaga (ed.), *Codes of good governance around the world* (pp. 523–542). Hauppauge, NY: Nova Science Publishers.

Tsui, J. S. L., Jaggi, B., & Gul, F. A. (2001). CEO domination, discretionary accruals and audit fees. *Journal of Accounting, Auditing and Finance*, *16*, 189–207.

Turpen, R. A. (1990). Differential pricing on auditors' initial engagements: Further evidence. *Auditing: A Journal of Practice and Theory*, *9*(2), 60–76.

Yatim, P., Kent, P., & Clarkson, P. (2006). Governance structures, ethnicity, and audit fees of Malaysian listed firms. *Managerial Auditing Journal*, *21*(7), 757–782.

Yee, C. S.-L., Sujan, A., James, K., & Leung, J. K.-S. (2009). Perception of Singapore internal audit customers regarding the role and effectiveness of internal audit. *Asian Journal of Business and Accounting*, *1*(2), 147–174.

APPENDIX

Individual Factors of CGINDEX

CGINDEX is the composite measure of corporate governance based on the MCCG. *MCCG_PT2* is a composite measure of corporate governance index based on Part 2 of MCCG, which requires firms to explain and provide alternative practices adopted when departing from best practices. *MCCG_PT4* is a composite measure of corporate governance index based on Part 4 of MCCG, which provides further best practices and explanatory notes to the principles and best practises set out in Parts 1 and 2. *BOARD* is board of director and composition, *AUD_ACC* is accountability and audit, and *SHA* is shareholders protection and communication.

1999–2002	**FACTORS**	**REFERENCES**
MCCG_PT2		
BOD_001	Does the company split the Chairman and CEO/Managing Director posts?	Section AA, Paragraph II
BOD_002	Does the company comply with MCCG recommendation on the proportion of independent directors on the board?	Section AA, Paragraph III
BOD_003	Is the frequency of board of directors' meetings disclosed?	Section AA, Paragraph XIV
NOM_001	Does the company have a nomination committee?	Section AA, Paragraph VIII
NOM_004	Are the majority of directors on the nomination committee independent?	Section AA, Paragraph VIII
NOM_003	Does the CEO not sit on the nomination committee?	Section AA, Paragraph VIII
NOM_008	Does the company disclose recommendations made by the nomination committee?	Section AA, Paragraph VIII
NOM_009	Does the company disclose methods of board appointments?	Section AA, Paragraph X
REM_001	Does the company have a remuneration committee?	Section AA, Paragraph XXIV
REM_002	Is the list of remuneration committee members disclosed?	Section AA, Paragraph XXIV
REM_003	Does the CEO not sit on the remuneration committee?	Section AA, Paragraph XXIV
REM_004	Are the majority of directors on the remuneration committee independent?	Section AA, Paragraph XXIV
REM_009	Does the company disclose recommendations made by the remuneration committee?	Section AA, Paragraph XXIV
AA_001	Are the majority of directors on the audit committee independent?	Section BB, Paragraph I
AA_002	Does the company disclose activities carried out by the audit committee?	Section BB, Paragraph II
AA_003	Does the company disclose a statement on internal control?	Section BB, Paragraph VII