

Conceptual Relationship between Corporate Governance and Audit Quality in Shari'ah Compliant Companies Listed on Bursa Malaysia

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Abstract

The issue of corporate governance has been a focus among researchers after the 1997/98 financial crisis. Many countries have implemented codes and guidelines of corporate governance to promote effective boards overseeing the operations of companies. In the case of Shari'ah compliant companies, boards still play a significant role and are responsible to ensure Shari'ah compliance. This paper reemphasises the conceptual relation between corporate governance mechanisms and audit quality. The corporate governance mechanisms are measured by board size, CEO duality, independent directors, financial experts on the audit committee, and the existence of an internal Shari'ah committee. There are numerous methods to measure audit quality including using audit fee and auditor reputation as proxies. The findings are mixed. This means that there is no consistent relationship between good corporate governance mechanisms and audit quality.

Keywords: corporate governance, audit quality, Shari'ah committee

1. Introduction

Audit quality is an important criteria to ensure that financial reports are reliable. One of the main responsibilities of corporate governance is to provide annual reports to shareholders and other stakeholders. Shari'ah compliant companies must maintain their Shari'ah compliance. All securities and transactions under the Islamic capital market (ICM) are permitted by Shari'ah. The Shari'ah Advisory Council (SAC) is a committee established by SC on May 16, 1996 in order to advice the Commission of Shari'ah regarding ICM matters. The Minister of Finance gave SAC the mandate to ensure ICM complies with Shari'ah principles.

The SAC comprises Islamic scholars, jurists, and experts in Shari'ah specifically in the area of Islamic finance and economics. The main role of SAC is to advice SC regarding Shari'ah matters related to ICM (Securities Commission, 2014). With SAC's advice, SC is able to issue proper guidelines regarding Shari'ah compliance. The establishment of SAC promotes harmonisation in determining the status of securities and enhance the public confidence as the securities have been endorsed by an established Shari'ah body.

SAC is also responsible due issuing a list of Shari'ah compliant securities. In classifying companies listed in Bursa Malaysia as Shari'ah compliant companies and non-Shari'ah compliant companies, SAC will analyse their core activities. Shari'ah compliant companies are companies with core activities not contrary with Shari'ah principles and has been approved and classified as Shari'ah compliant by the SAC (Othman, 2009). Non-Shari'ah compliant companies' core activities deal with elements that are non-permissible by Shari'ah. For example, interest (*riba*), uncertainty (*gharar*), gambling and produce and sell goods and services prohibited by Shari'ah.

The list will be issued twice a year to help investors identify the status of securities as well as to increase investor's confidence. The status of securities will be determined based on classification of securities using revised screening methodology. The revised screening method includes a two-tier quantitative approach which involves business activity benchmarks and financial ratio benchmarks (Securities Commission Malaysia, 2013). Companies will be classified under Shari'ah compliant companies if they are within both benchmarks.

Under business activity benchmarks, SAC will measure the level of non-permissible income. Level of non-permissible income is the contribution of income of non-compliant activities in the total revenue and profit before taxation (Sani & Othman, 2013). The two benchmarks under business activity benchmark are the five percent benchmark and the 20 percent benchmark. To be classified as Shari'ah compliant, the contribution of non-Shari'ah compliant activities to the total revenue and profit before taxation must be less than five and 20 percent based on the specific conditions for both benchmarks. The previous screening method does not include financial ratio benchmark. To increase the quality of screening process, the financial ratio benchmark was adopted by the SAC effective November 2013. Under the financial ratio benchmark, SAC focuses on analysing the cash over total assets ratio and debt over total assets ratio. Both ratios were used to measure interest (*riba*) or interest-based elements within the company and must be less than 33% to be qualified as Shari'ah compliant companies (Securities Commission Malaysia, 2013). Even though companies' securities were classified as Shari'ah compliant, the investment was open to Muslims and non-Muslims. Thus, boards of directors still play a significant role to ensure that companies are Shari'ah compliant.

This paper highlights the possible conceptual relationship between audit quality and corporate governance mechanisms.

2. Audit Quality

External financial auditing is usually viewed as an aid to reduce agency conflicts (Francis & Wilson, 1988). According to Boone, Khurana, & Raman (2010), information asymmetries could be reduced by having quality financial report since it provides quality information as it maps the earnings well. On the other hand, rather than only focusing the effects of audit quality on trustworthiness of financial reporting, many prior studies chose to focus on factors of audit quality (O'Sullivan, 2000; Kane & Velury, 2005; Al-Ajmi, 2009; Makni, Kolsi, & Affes, 2012). Generally, the public assumes that companies will choose the best auditors to obtain good audit quality. Boone et al. (2010) found that investors perceived that audit quality is higher for Big 4 firms. This indicates that the audit quality is associated with the selection of auditors. However Z. J. Lin & Liu (2009) stated that audit quality implies that the benefits of audit such as monitoring device outweighs the cost of applying that device. High quality audit will benefit the company as it will raise funds resulting from reduction in information asymmetries from auditing (Z. J. Lin, Liu, & Wang, 2009; Z. J. Lin & Liu, 2009).

With respect to empirical studies, Piot (2001) examined the influence of agency cost on demand of audit quality wherein agency cost refers to ownership concentration and leverage. He found that only leverage influenced the demand of audit quality. It is also supported by research by Broye & Weill (2008) which discovered that there is a positive association between audit quality and leverage. Karjalainen (2011) found that perceived audit quality is applicable in pricing of debt capital for private firms. Furthermore, impact of audit quality on debt pricing for the newly public firm is larger than other years since they are not known at this time (Pittman & Fortin, 2004). In order to reduce agency costs, foreign investors need quality financial reports (Guedhami et al., 2009). Leuz, Lins, and Warnock (2008) found that foreign investors do not prefer to invest in less governed firms.

Because of the demand on ICM is increasing among investors, Shari'ah compliant companies need to have quality audit in order to increase the investors' confidence in raising funds. There is no reason to believe that audit quality is less important for Shari'ah compliant companies. This is because all companies are obliged to undergo audit. Auditing is important to ensure the quality and trustworthiness of financial reporting (J. W. Lin & Hwang, 2010). Outside investors who usually have less information about a firm's operation, depend more on annual audits to analyse and evaluate the company that they invested in. For instance, the auditors will relay the information to the investors that the Shari'ah compliant companies conduct their business and report earnings in a responsible manner. Here, the credibility of auditors is important since it will determine the utility of the information reported in the annual audit to the investors.

Due to corporate accounting scandals, the role of auditing in ensuring the quality of financial reports has become a serious concern. Earnings management indicates that the audit failure represents the poor quality of audit (Francis, 2004). This means that audit quality may avert earning management in a firm. Becker et al. (1998) examined the relationship between earning management and audit quality whereby the Big Six auditors act as proxy of audit quality. They found that clients of non-Big Six manage their earnings as they increased their income more than the clients of Big Six auditors. On the other hand, J. W. Lin & Hwang (2010) verified that audit quality has a negative relationship with earnings management.

3. Measurement of Audit Quality

The measurement of audit quality varies. There is lack of consensus regarding the measurement of audit quality. Many prior research use Big Four/Non-Big Four as proxy of audit quality. Even though Boone et al. (2010)

stated that audit quality is higher among Big 4, other factors still need to be considered such as size of audit firm (Al-Ajmi, 2009; Adeyemi & Fagbemi, 2010), audit specialization (Almutairi, 2013), auditor reputation (Piot, 2001; Makni et al., 2012), auditor experience (Johnstone & Bedard, 2004), and ICT used in audit procedures (Bedard, Jackson, Ettredge, & Johnstone, 2003).

Boone et al. (2010) suggested that litigation costs and reputation loss are the two primary drivers for audit quality. Auditors want to avoid litigation costs as it reflects the poor quality of audit and reputation loss would be the long-term consequence for insufficient audit quality. The most common indicators for audit quality are auditor size (Al-Ajmi, 2009; Makni et al., 2012), audit fees (O'Sullivan, 2000; J. W. Lin & Hwang, 2010), and auditor reputation (Hope, Kang, Thomas, & Yoo, 2008; Makni et al., 2012). These indicators are relevant to the Big Four auditors This is because they are known for their best reputation and highest price despite of being the largest audit firm in the world. In fact, Hay, Knechel, & Wong (2006) mentioned that Big Four auditors is commonly used as a proxy of audit quality. Number of empirical studies supported that Big Four auditors are related to high quality of auditing (De Angelo, 1981; Defond et al., 1993; Francis, 2004; Dechow, Ge, & Schrand, 2010; Dehkordi, 2011).

Even though there is evidences stating that the use of Big Four auditors is related to audit quality, this study preferred to use audit fees as proxy of audit quality because audit fees more likely reflect the auditors' effort since the audit market is regulated and the opportunity to gain on the fees is limited (Kanagaretnam et al., 2011).

Yasin & Nelson (2012) also adopt audit fees as a proxy of audit quality. They mentioned that higher audit fees charged indicates that auditors provide more efficient audit services to clients compared to lower audit fees. According to O'Sullivan (2000), thorough investigation requiring audit specialization and hours will lead to higher audit fees. Thus, it is expected that higher audit fees indicate higher audit quality since more audit work is required to ensure financial statements are free from material misstatements (Yasin & Nelson, 2012).

4. Corporate Governance

The most important corporate governance mechanisms are board size, CEO duality, independent directors, financial experts on the audit committee, and existence of an internal Shari'ah committee.

4.1 Board Size and Audit Quality

Studies regarding the relationship between board size and its efficiency has drawn the interest of researchers including Jensen (1993) and Pahuja (2011). According to Jensen (1993), the board needs to remain small in order to improve firm performance. He argued that boards that exceed seven or eight members will function less efficiently because of high levels of conflict. This is supported by Lipton & Lorsch (1992) who recommended that limiting board members to seven or eight will reduce inefficiency. This is because the coordination and process problems outweigh the benefits of having more members in the board.

In contrast, Pearce & Zahra (1992) stated that there is a positive association between board composition and company performance. They suggested that larger boards will better understand the diverse stakeholders. It will also reduce the tendency of CEO domination in the board. Andres & Vallelado (2008) expect that the board must be larger since it will facilitate the monitoring process on management and provide advice to managers. This is supported by Pfeffer (1972) which stated that larger board size indicates more monitoring resources, thus increasing firm performance. Large board size does increase company's monitoring abilities on management, but companies need to bear the cost (Jensen, 1993).

Beasley (1996) found the association between size of board of directors and the likelihood of financial frauds. His results reveal that increase in board size will increase the likelihood of financial statement fraud. This means that the size of the board will affect the process of financial reporting as well as auditing process. Thus, larger board size seems to be less effective as a monitoring tool for financial reporting. Furthermore, managers will face difficulties in making decisions when there is a large board of directors due to difficulties in communication. Large board size will increase the tendency of free-riding. Yermack (1996) reached a similar conclusion where small board is more preferable since it shows favourable financial ratios than larger board. Small boards also provide better CEO performance because they are able to monitor decisions made by managers.

In Malaysia, the average number of board members is 7.51 (Yatim et al., 2006). According to Salmon (1993), in order to ensure sufficient expertise in the board, its size should be large enough. However, it should not be too large because communication problems and free-riding might occur among directors. The role of monitoring is more important when the board size is large. Board of directors will prefer high quality auditors as their monitoring tools.

4.2 CEO- Duality

This study determines the relationship between CEO-duality and audit quality. CEO-duality refers to a practice by an individual who serves as CEO and the chairman of the board at the same time. The combination of the two functions has several effects on the board and will result in poor performance. Ineffectiveness of the board with CEO duality occurs due to conflict of interest. It raises the question of board independence since CEO-duality will be the barrier for separation of control and decision making (Daily & Dalton, 1993). The majority of corporate governance systems often recommend separating the positions of chairman of the board of directors and CEO.

CEO-duality is normal in Malaysia (Abdullah, Ismail, & Jamaluddin, 2008). This may be due to the nature of family owned businesses preferred by corporations in developing countries like Malaysia. Family owned businesses have a tighter ownership concentration and have a slower asset turnover, leading to a low book value of assets (Yermack, 1996). This means that big firms able to have different person for CEO and chairman of board of directors normally trade the higher price to book value (Zanani & Abdullah, 2008; Yermack, 1996). The Malaysian Code on Corporate Governance (2012) recommends that the position of CEO and chairman of the board of directors should be held by two different persons and the chairman should be a non-executive director in order to encourage board independence.

In contrast, Ramdani & Witteloostuijn (2010) concluded that CEO-duality improves performance for mediocre enterprises. CEO who is the manager of the company is expected to choose high quality audit as a mechanism to increase their compensation (Francis & Wilson, 1988). Based on agency theory, separation of ownership and control will reduce the agency cost and improve firm performance (Jensen & Meckling, 1976).

Researchers such as Fama & Jensen (1983) and La Porta, Lopez-de-Silanes, Shleifer, & Vishny (2000) focusing on internal corporate mechanisms, argue that board's interest must be aligned with shareholder's interest. Hence, CEO-duality will have negative impacts on internal control mechanisms since the interest of managers differ from the board's interest. Furthermore, weaknesses in internal control and lack of information transparency will lead to corruption within the company and manipulation of financial reports. J. W. Lin & Hwang (2010) stated that lack of control in corporate governance mechanisms will result in CEO-duality and earnings management. This is supported by those who investigate the relationship between independence and duality in board and fraud concluding that there is a positive relationship between duality and likelihood of fraud.

4.3 Independent Directors and Audit Quality

The best control mechanism in monitoring management's actions is the board of directors (Fama & Jensen, 1983). Agency theory focuses on board independence to ensure the effectiveness of the monitoring process. Independent directors are directors who do not have any family relationship with those holding power or hold any shares in the firm. Their decisions align with shareholders' interests. Beasley & Petroni (2001) stated that based on the assumption of agency theory, the presence of independent directors will increase the effectiveness of the board. According to Fama & Jensen (1983), outside directors who represent the shareholders will monitor the management's decision making and have higher incentives to prevent or detect any opportunistic behaviour of management. The incentive of board of directors is driven by three factors.

First, directors tend to protect reputation because they are known to the public as expert in monitoring management. They will be blamed for a company's poor performance or corporate problems. Second, from legal perspectives, directors are subject to severe sanctions if they fail to exercise the monitoring responsibilities reasonably. Thirdly, as representatives of shareholders, directors need to protect shareholder's wealth since shareholders suffer a major loss due to the company's financial problems. In protecting shareholder's wealth, directors may seek high quality audit services (Carcello et al., 2002). Consequently, outside directors who face less conflict of interest are expected to prefer audit quality more than executive directors.

There are two perspectives to explain the relationship between proportion of independent directors and the selection of high quality auditors. The first perspective focuses on the substitution effect between effective rule by outside directors and the selection of reputed auditors. Empirical research by Lee et al. (1992) concluded that there is a positive association between proportion of outside directors and effectiveness of the board. Effectiveness refers to strict controls to govern the management and align their interest with shareholders' interest. The second perspective is supported by O'Sullivan (2000) and Beasley & Petroni (2001) who proclaimed that proportion of non-executive directors in the board has a significant positive impact on the demand of higher audit quality.

Beasley & Petroni (2001) found that boards with high proportion of outside directors demand higher quality

auditors to ensure effectiveness in monitoring the management. They suggested that non-executives directors capable to bring greater independence in the board will demand intensive audits to complement their monitoring role. In addition, Lennox (2005) claimed that outside directors influence the board's decision by demanding high quality audit to ensure the fairness and credibility of financial reporting as well as reducing information asymmetries. In addition, a balance of independent directors which explain the effectiveness of the board will improve the quality of audit services by external auditors. This explains the relationship between these two governance mechanisms.

4.4 Financial Expertise and Audit Quality

In order to enhance investors' confidence on financial reporting, audit committee should be effective enough. Audit committee acts as an operating committee of board of directors which oversight the process of financial reporting and disclosure. According to Yatim et al. (2006), the effectiveness of audit committee could be further enhanced if the audit committee members acquire accounting and financial expertise. Financial experts in audit committee must understand accounting principles and standards, know which appropriate accounting policies to be used based on business environment, understand company's internal control in order to safeguard assets, and protect shareholder's rights by reducing the opportunity of financial restatement (Alkdai & Hanefah, 2012).

Many regulatory and professional bodies recommend that audit committee members should have specific qualification in discharging their responsibilities. For example, Blue Ribbon Committee (1999) recommended that the audit committee of listed companies in the New York Stock Exchange (NYSE) and National Association of Securities Dealer (NASD) which has market capitalization over \$200 million should comprised of a minimum three members who are financially literate as stated in Recommendation 3. In addition, at least one member of the audit committee should have financial expertise. The Sarbanes-Oxley Act of 2002 also mandates that at least one financial expert should be in the audit committee. In Malaysia, Bursa Malaysia mandates in its listing requirement that at least one of the audit committee members must be a member of the Malaysian Institute of Accountants (MIA). This shows that financial expertise is important for the audit committee to function effectively.

Empirical research supported that audit committee should be comprised of at least one financial expertise. Ruzaidah & Takhiah (2004) found that the listed companies in Malaysia with audit committee comprising financially literate members have higher possibilities of producing good annual reports. They argued that audit committee members with knowledge in accounting and finance are able to discharge their responsibilities well in monitoring internal controls and financial reporting. Good annual reports indicate that audit committees oversee the financial reporting process thereby increasing the quality of financial statements. Quality financial statements reduce the probability of financial statements restatement. This is supported by Abbott, Parker, & Peters (2004) who stated that audit committees comprising of at least one financial expertise have a negative association with restatement of financial statements.

Directors who have financial expertise might be familiar with earnings management and take appropriate measures to curb the problem. Xie et al. (2003) and J. W. Lin & Hwang (2010) found that earnings management is less likely to occur when audit committee has financial expertise. However, J. W. Lin et al. (2006) did not find such a significant relationship between audit committee's financial expertise and earnings management. DeZoort, Hermanson, Archambeault, & Reed (2002) stated that audit committee with financial expertise is more likely to detect material misstatements. Manipulation by interested parties is expected to minimise by having financial expertise in audit committee (Ruzaidah & Takhiah, 2004). Investors will react positively in appointment financial expertise in audit committee since they are equipped with financial and accounting knowledge and are able to curb earnings management. In contrast, Ismail, Iskandar, & Rahmat (2008) observed there is no difference of audit quality regardless of the number of financial experts in the audit committee.

4.5 Internal Shari'ah Committee

The unique feature of corporate governance among Shari'ah compliant companies is having an internal Shari'ah committee. Currently, Malaysia has a Shari'ah Governance Framework designed for Islamic Financial Institutions (IFIs) to enhance the role of companies' board, committee, and management regarding Shari'ah matters (Ramli et al., 2014). The framework is effective from 1 January 2011 whereby IFIS gave six months to comply with the framework. The scope of application for this framework is all IFIs regulated and supervised by the Central Bank. The introduction of this framework led the majority of IFIs to establish their own Shari'ah board at the institutional level. In order to support Shari'ah boards in performing their duties, some companies established an internal Shari'ah review unit or department (Hasan, 2010). This shows a positive development of corporate governance in IFIs. This is supported by Ramli et al. (2014) which stated that the Shari'ah governance

framework is moderately disclosed in IFIs annual reports. For IFIs in Malaysia, Bank Negara has introduced a two-tier Shari'ah governance infrastructure to ensure IFIs operate according to Shari'ah principles. The two-tier governance structure comprises centralized SAC at Bank Negara level and internal Shari'ah committee formed in each respective IFI.

In the context of Shari'ah compliant companies, the Shari'ah Governance framework does not state that it is applicable to them. However, the framework could be a guideline since it also complies with Shari'ah. The two-tier governance structure also applies to Shari'ah compliant companies whereby for them they have 1) the centralized SAC at Securities Commission level and 2) the internal Shari'ah committee form in respective Shari'ah compliant companies. SAC is responsible for issuing a list of Shari'ah compliant securities twice a year. Large companies with more resources are able to have their own internal Shari'ah committee to ensure their operations comply with Shari'ah.

Despite its importance, there are minimal studies on internal Shari'ah committee among Shari'ah compliant companies. Many prior studies focused on the Shari'ah governance structure among IFIs and Takaful companies (Ramli et al., 2014; Bukhari, Awan, & Ahmed, 2013; Kasim et al., 2013; Abu Kasim, 2012; Sawari, Hassan, & Abdullah, 2011). Based on signalling theory, competence work by Shari'ah committee in IFIs will provide indication to investors that the institutions' operations are good and accord with Islamic values (Rahim et al., 2012). There is a great challenge for the Shari'ah committee which is the implementation of Shari'ah audit function. This is different from traditional Shari'ah committees which only focus on advising the management. The introduction of Shari'ah the governance framework requires Shari'ah committees not to only exercise advisory role but also monitoring. Its main function is to help Shari'ah committees ensure that implementation of products or transactions comply with Islamic principles (Shafii, Abidin, Salleh, Jusoff, & Kasim, 2013). This adds value to the Shari'ah committee role. This unique feature of governance has caused managers to demand high quality auditors with expertise and experience in the Shari'ah environment.

5. Conclusion

Corporate governance is relatively new and its important roles have been acknowledged. However, empirical tests on the relationship between the corporate governance mechanisms and audit quality are mixed. Some of the findings are in line with theory while some are not. This may be due to the many ways to measure audit quality which might be influenced by the statutory background, the operational function of the companies, and culture. Thus, the paper is important for policy makers to consider which mechanisms are really suitable for the industry.

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