

OWNERSHIP CONCENTRATION, POLITICAL CONNECTION AND AUDIT FEES: SOME EVIDENCE FROM MALAYSIAN CAPITAL MARKET

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Abstract

The purpose of our study is to examine how share ownership concentration and political connection determine audit fees in Malaysia. These two determinants, ownership concentration and political connection, are very important, especially, in the context of Malaysia where many companies have very high share ownership concentration and are politically connected. We examine 162 companies listed on the Malaysian Stock Exchange and employ cross-sectional regression analysis to determine the relationship between ownership concentration, political connection and audit fees. We observe that highly concentrated share ownership firms are able to influence priorities of the board to focus on the provision of resources rather than monitoring. Our results suggest a negative association between audit fees and politically connected firms. We also find that higher proportion of independent directors on the audit committee of politically connected firms demand auditors to put additional efforts on the politically connected firms which leads to an increment in the audit fee charged. This suggests that regulators should encourage companies to form an effective audit committee for high quality audit services to ensure that firm is able to minimize the risk exposure. The findings of the study are appealing to literature of political connection and audit fees.

Keywords: Ownership Concentration, Politically Connected Firms, Audit Fees, Malaysia

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1. Introduction

The objective of this paper is to examine the relationship between ownership concentration, political connection and audit fees in Malaysia after the Asian financial crisis. Recently, there has been much debate regarding the need for strong corporate governance due to the integration of securities markets (Goodwin and Seow, 2002). It has been argued that sound corporate governance may influence the quality of financial reporting which may have an important impact on investors' confidence. Moreover, this issue has become important after the corporate collapses occurred in the U.S., EU, Australia and Malaysia. These include Enron, WorldCom, Parmalat, Swiss Air, HIH Insurance,

Harris Scarfe, OneTel and Renong. These events had significant impact on the investors' confidence in the capital markets throughout the world (Monem and Farshadfar, 2007). As a result, enormous efforts were given to reinforce quality of corporate governance including external audit practices and independence (Gonthier-Besacrier and Schatt, 2007). After the collapses of these firms, market regulators of many countries impose stricter regulations including Malaysia.

Corporate governance helps to enhance corporate transparency and accountability, and is assumed to have significant influence on audit fees. We use agency theory to explain the relationship between ownership concentration and audit fees. Jensen and Meckling (1976) provide a framework

linking disclosure behavior to corporate governance. According to the agency theory managers are separated from owners of the company, therefore, they may use accounting numbers opportunistically to maximize their wealth. To mitigate the agency costs firms with higher agency costs usually hire costly auditor which ensure audit quality (Gul and Tsui, 1998). Watts and Zimmerman (1986) argue that the use of quality audit service seems to resolve the costly contracting problems. Large shareholders appear to have the capacity to monitor and influence managers of the firms (Monks and Minow, 2002).

A number of researches have examined the influence of ownership structure and quality of accounting information in the financial statements (e.g., Gul *et al.*, 2002; 2003). Prior research has concentrated primarily on audit fees and corporate governance variables largely focused on U.S. capital market. However, limited studies examine the relationship between audit fees and corporate governance in East Asian countries (see Gul and Tsui, 2001; Gul, 2006). Gul and Tsui (1998) investigated the impact of debt and cash flow on audit fees and found a positive relationship between free cash flow and audit fees. In 2001, Gul and Tsui extended the work of Gul and Tsui (1998) by including the director ownership, as a proxy for management ownership in the analysis and observed that low growth firms with high FCF were associated with higher inherent risk that requires higher audit efforts leading higher audit fees. Later Gul, Chen, and Tsui (2003) investigated the linkage between discretionary accruals, managerial share ownership, management compensation, and audit fees. They found a positive relationship between discretionary accrual and audit fees. This relationship was weaker for firms with high managerial ownership.

Using corporate governance variables, Carcello *et al.* (2002) examined the relationship between board characteristics and Big 6 audit fees. They argued that a more independent, diligent, and expert board demands higher audit quality which requires more audit efforts in order to protect firms capital, reputation, avoid legal liability, and promote shareholder interests. They found that the audit fee increases with the auditor's additional works which they charged to their clients. Abbott *et al.* (2003) examined the association between audit committee characteristics and audit fees, and observed that audit committees comprising solely of independent directors and having at least one financial expert are related with higher audit fees. Their results indicate that greater independence and expertise of audit committees ensure enhanced oversight of the management-auditor relationship. Recently, Mitra *et al.* (2007) examined the association between ownership characteristics and audit fees. They argued that highly concentrated share owners actively involve in firms' activities along with the preparation of financial statements and reporting of information.

As a result, the inherent audit risk and audit fees seem to be lower since the likelihood of material misstatements of financial statements is low. The authors reported a positive relationship between diffused institutional stock ownership and audit fees, and negative relationship between institutional blockholder ownership and audit fees. Furthermore they also report a negative relationship between managerial stock ownership and audit fees.

In addition to corporate governance and audit fees studies, there have been extensive research addressing the impacts of political connections on Audit fees (see Johnson and Mitton, 2003; Faccio *et al.*, 2004; Cheung *et al.*, 2005; Gul, 2006; Chaney *et al.*, 2011). Faccio *et al.* (2004) analyzed the likelihood of government bailout for a sample of 357 politically-connected firms from 35 countries for the period of 1997 to 2001. They found that political connections result in higher likelihood of a company bailout. Chaney *et al.* (2011) investigated the quality of accounting information in politically connected firms, and found that the quality of accounting information disclosed by politically connected firms were significantly poorer than non-politically connected firms. Moreover, they also found that highly politically connected firms had the poorest earnings quality. Cheung *et al.* (2005) examined whether political connections affect the value of the firm by analyzing connected transactions between Chinese listed firms and their state-owned enterprise shareholders. Their results indicated that political connections in China are detrimental for minority shareholders. Johnson and Mitton (2003) assessed whether firms with political connections influenced stock returns in Malaysia. They observed that firms with political connections had worse stock returns in the beginning of the Asian financial crisis. However, once capital controls were imposed politically connected firms performed well. Later, Gul (2006) investigated the role of corporate political connection in audit pricing in Malaysia during 1996 to 1999 and found an increase in audit fees for politically connected firms than non-politically connected firms during the Asian financial crisis. In contrast, the author also observed a decline in audit fees for politically connected firms after the capital controls were put in practice. However, no studies have included political connection in audit fees model after financial crisis. However, no studies have included political connection in audit fees model after financial crisis. This study extends the existing literature by using post Asian crisis data in the context of Malaysia when the corporate governance became a topical issue.

In the Malaysian context, the issue of ownership concentration, political connection and audit fees has been seen with the greater interest since the enforcement of capital control in the early 2002. This issue is worthy to study for several reasons. First, recently corporate governance issue has been

emphasized by the securities exchange commission in Malaysia. In the US and the UK while separation from ownership and control is the main form of corporate governance, Malaysia listed companies are mostly owned by executive directors and substantial shareholders.

It has been argued that many Asian countries have highly concentrated share ownership structure (La Porta *et al.*, 1999). The post Asian crisis period has been depicted as the major era in Malaysia because there have been substantial changes in the regulation of corporate governance by the securities regulators. These changes demand companies to be audited by the external auditors which provide quality audit service. Second, although Gul (2006) tested whether highly politically connected firms led to higher audit fees during the Asian crisis, no studies have been conducted after the Asian crisis with politically connected firms in general. We extend Gul (2006) study including politically connected firms rather than highly politically connected firms that further enhance the generalizability of the results. Therefore, this study provides an opportunity to examine the characteristics of corporate governance, political connection and audit fees in the Malaysian context. Understanding the impact of ownership concentration and political connection variables will provide an insight on the audit fees.

We employ cross-sectional regression analysis and observe that highly concentrated ownership firms are able to influence monitor management, hence, reduce the audit fees. Our results indicate a negative association between audit fees and politically connected firms. We also find that higher proportion of independent directors on the audit committee of politically connected firms demand the auditor to put additional efforts on the politically connected firms which leads to an increment in the audit fee charged.

The remainder of this paper is organized as follows. In Section 2 we develop hypothesis for the study. Section 3 describes the research design. We document the result of our study in Section 4 while conclusions and implications of the study are discussed in Section 5.

2. Hypotheses development

2.1 Ownership concentration and audit fees

The theory behind corporate governance is mainly derived from the agency theory propagated by Jensen and Meckling (1976). Fama and Jensen (1983) argued that the separation between ownership and management is the origin of corporate governance problem. Agency approach to corporate governance identifies the conflicts of interest between shareholders and management (Yuan *et al.*, 2004). Agency problems occur when decisions are made by the management that is inconsistent with the

shareholders. However, these problems are taken into consideration under corporate governance structure by separating the decision management and decision control (Li, 1994).

According to Shleifer and Vishny (1997), concentration ownership is one of the most important ways to solve the agency problem. Concentrated owners are able to influence and monitor management. Small shareholders may not monitor the performance of managers of the firm, while large shareholders have ability to monitor managers' activities because of their significant economic stakes (Shleifer and Vishny, 1986). Grossman and Hart (1980) contended that shareholders in a diffusely held firm may not monitor managers because small shareholders may not power to absorb the costs to monitor management. Nevertheless, monitor of management is possible by the large shareholders of the firm since they are the largest consumers of the public goods, hence will engage in value-increasing changes in corporate policy. La Porta *et al.* (1999) observed that like East Asian countries, many large corporations in the developed countries are closely held regardless of the size of the firm. Large corporation try to limit expropriate minority shareholders by controlling shareholding (La Porta and Lopez-de-Silanes, 1998).

Hoskisson *et al.* (2000) and La Porta *et al.* (2000) argued that in developing countries since property rights are under-developed, investors of the firm experience severe information asymmetry problem. corporate governance researches in developing countries document that firm's ownership structure is responsible for the principal-agent conflict (Su *et al.*, 2007; Chang, 2003; Clasessens *et al.*, 2002). According to them conflict between large and small shareholders cause these problems. Su *et al.* (2007) argued that minority shareholders are expropriated by the large shareholders since property rights are not appropriately enforced by the legal institutions in emerging economies.

Large shareholders have the capacity to appoint representative to the board of directors and take part in the management. Prior studies by Claessen *et al.* (1999) and Liew (2007) found that Malaysia has very high share ownership concentration in East Asia. Concentrated shareholding can monitor management and firms' activities including financial accounting, reporting and disclosure practices that eliminate the perceived inherent audit risk (Mitra and Cready, 2005). The auditors spend lesser audit effort and, hence, charge lower audit fees due to perceived lower inherent audit risk. Therefore, the following hypothesis is formulated:

H₁: There is a negative relationship between the audit fees and concentrated share ownership.

2.2 Political connection

Political connection can be defined as, “connections with government ministers include cases in which the politician himself is a large shareholders or a top director, as well as cases where a politician’s close relative (e.g., the son or daughter) hold such position” (Chaney *et al.*, 2011 p. 60). Gomez and Jomo (1997) identified two types of political favoritism in Malaysia: first, official status that is given to the ethnic Malays and second informal tie between Malay and Chinese businessmen. Although, the Muslim-majority Malays make up about 60 percent of the population, ethnic Chinese dominate about the 25 percent of business sector. In 1971 the Malaysian government launched the New Economic Policy (NEP) with initiatives to narrow the wealth gap between the Chinese and Malays. One of the objectives of NEP was to achieve 30 percent Bumiputra ownership of the corporate sector by 1990. The government introduced policies that involved positive action towards the Bumiputras. Priority for government licenses and contracts, increased access to capital and opportunities to buy privatized assets and subsidies in terms of low-interest loans from government financial institutions were more likely to be given to the Bumiputras (Gomez and Jomo, 1997).

The above issue has been examined by Gul (2006) and tested whether audit fees of politically connected firms have been increased as a result of the Asian financial crisis than non-politically connected firms in Malaysia. The author found a greater increase in audit fees for politically connected firms than non-politically connected firms. Nevertheless, audit fees of politically connected firms declined after the capital controls were imposed. Gul (2006) argued that auditors seemed to have higher audit risk for the politically connected firms during the financial crisis than the non-politically connected firms. The reason for this is that politically connected firms were associated with business failure and misstatement of financial reporting to avoid debt default. This may result higher audit fees because of the increased efforts provided by the auditors. In contrast, less audit risk for auditors was involved for politically connected firms after the capital controls were imposed in 1998. This resulted lower audit efforts and lower audit fees. His research was conducted during the Asian crisis for highly politically connected firms. However, audit fees seem to be lower after the imposition of capital controls for politically connected firms. Gul (2006) used highly politically connected firms in the sample while we use politically connected firms in general. This leads to the development of the following hypothesis:

H₂: There is a negative relationship between the audit fee and highly politically connected firm.

2.3 Independent directors on the Audit Committee

The role of the audit committee has received increased attention in recent years (Mangena and Taurigana, 2008) since the corporate scandals involving Enron and WorldCom, Nortel and Crocus, Parmalat and Royal Ahold, Renong and HHH Insurance shook the capital markets in developed and developing countries. In the United Kingdom, the Cadbury Committee (1992) recommended all listed companies should establish an audit committee. The audit committee monitors those responsible for preparing financial statements and additionally monitors the internal and external auditors of the company. The existence of an audit committee should enhance the quality of financial reporting and act as a mechanism for controlling management (Collier, 1993). Agency theory suggests that the setting up of audit committees and the appointment of non-executive directors on the audit committee should attenuate agency costs (Forker, 1992).

The Kuala Lumpur Stock Exchange (KLSE) Listing Requirements is the establishment of an audit committee since 2001. The composition of an audit committee is, as required by regulation, that at least two third of the committee members are independent directors. Carcello, Hermanson, Neal and Riley (2002) and Abbott *et al.* (2003) contended that an effective audit committee will lead to an increase in the audit fees charged by the auditor. Mitra *et al.* (2007) also posited that the presence of independent directors on audit committee increases the audit fee charged. However, Collier and Gregory (1996) found evidence that the existence of an audit committee is associated with higher size related audit fees in relation to the size of the client, and provide weak evidence for the association between audit fees and audit committee with the complexity of the firm. These authors provide no evidence that audit committees have any affect on the audit fee charged in relation to the perceived risk of the firm. This leads to the development of the following hypothesis from demand perspective:

H₃: There is a positive relationship between the audit fee and effective audit committee of a firm.

2.4 Interaction between the politically connected firms and proportion of independent directors on audit committee

Gul (2006) finds that Malaysian highly politically connected firms after the imposition of capital controls have lower audit fees as potential motivation for managers of these firms to mis-state financial statements reduced. This would lead auditors to make less effort because auditors perceive lower risk in these firms. However, the presence of effective audit committee will demand for higher audit fees. A prior

study by Carcello *et al.* (2002) argued that effective board in terms of independence, diligence, and expertise are positively associated with audit fee. Additionally, Abbott *et al.* (2003) argued that an effective audit committee will lead to an increase in the audit fees charged by the auditor. Mitra *et al.* (2007) also conjectured that the presence of independent directors on audit committee increases the audit fee charged. Prior studies' (Carcello *et al.*, 2002; Abbott *et al.*, 2003; Mitra *et al.*, 2007) argument are from the demand perspective as the effective audit committee may induce the firms to purchase high-quality audit service. The presence of effective audit committee may demand the auditor to take more effort on the politically connected firms as these firms are perceived to have higher risk since the financial crisis in Malaysia. In a highly perceived inherent risk, auditors will increase the amount of audit effort and charge higher audit fees. To test this relationship the following hypothesis is proposed:

H₄: The presence of effective audit committee on politically connected firms in Malaysia has a positive association on audit fees.

3. Research Design

3.1 Collection of Data

The sample used for testing the hypotheses consists of the Malaysian 200 public listed companies in terms of market capitalization non-finance listed companies for the financial year 2001. Finance companies were excluded because they report under the Banking and Financial Institution Act 1989 (BAFIA) and are considered not to be good candidates for testing of the hypotheses. This is because the finance companies are governed under a different regulatory body. The final sample consists of 162 companies after screening for share ownership concentration firms, and deleting outliers (top 1 percent of the sample with very high audit fees).

3.2 Measurement of Dependent and Independent Variables

The dependent variable, audit fee is measured by taking the natural log of audit fee paid by the firm from the company's annual report. The independent variable, share ownership concentration (OWNCON) data was manually collected from the 2001 annual

$$LAFEE = \beta_0 + \beta_1 OWNCON + \beta_2 INDAC + \beta_3 PC + \beta_4 PC * INDAC + \beta_5 AUD + \beta_6 FSIZE + \beta_7 SUBS + \beta_8 CR + \beta_9 MKB + \beta_{10} LEV + \beta_{11} LOSS + \beta_{12} YE + \beta_{13} FORS + \varepsilon$$

where:

LAFEE	=	Natural log of audit fees,
OWNCON	=	Percentage of shares owned by 10 largest shareholders to total number of shares share
PC	=	Indicator variable, 1 for politically connected firms
INDAC	=	Proportion of independent directors on the audit committee
PC*INDAC	=	Interaction between politically connected firms and INDAC

reports. This is represented by ownership concentration shareholding in companies which is measured by top ten substantial shareholders. The variable independent directors (INDAC) are measured as the proportion of independent directors on the audit committee. The politically connected firms are identified based list of the companies disclosed by Johnson and Mitton (2003). This is a binary variable coded as '1' if the firm is politically connected and '0' otherwise.

3.3 Control variables

The control variables include size of audit firm (AUD), firm size (FSIZE), number of subsidiaries (SUBS), current ratio (CR), market to book value of equity (MKB), leverage (LEV), loss making firms (LOSS), year end (YE) and foreign subsidiaries (FORS) which are based on prior research (see Simunic, 1980; Craswell *et al.*, 1995; Gul and Tsui, 1998; Gul, 2006; Mitra *et al.*, 2007). The control variable AUD represents auditor is a binary variable coded as '1' if the firm is audited by BIG 4 and '0' otherwise. The FSIZE is measured by the log of market capitalization. SUBS represent subsidiary companies and are measured as the square root of subsidiary companies held by the firm. CR represents the current asset ratio and is measured by dividing the current assets with current liabilities. IOS is the market to book ratio and is measured as the market price per share divided by the book value per share. LEV represents the leverage of the firm and is measured as non-current liabilities divided by total equity. The LOSS variable is measured as a dummy variable of '1' if a loss was recorded during the year and '0' otherwise. Year-end (YE) is measured by a dummy variable of '1' if the year-end is December 31st and '0' otherwise. FORS represent foreign subsidiary companies and are measured as the number of foreign subsidiaries. Firms with greater proportion of subsidiaries require more audit work as need to comply with reporting requirements in the countries where they operate (Collier and Gregory, 1996).

3.4 Model specification

The following model is employed to test the hypotheses:

AUD	=	Firms audited by big 5 audit firms
SIZE	=	Log of market capitalization
SUB	=	Square root of number of subsidiaries
CR	=	Current assets divided by current liabilities
MKB	=	Market price per share divided by the book value per share
LEV	=	Non current liabilities divided by total Equity
LOSS	=	Indicator variable, 1 for loss making firms
YE	=	Indicator variable, 1 for fiscal year ending 31 December
FORS	=	Natural logarithm of the number of foreign subsidiaries

4. Results

4.1 Descriptive statistics

The descriptive statistics for both the dependent and independent variables are reported in Table 1. The audit fees vary from RM 8000 to RM 746,000 with a mean of RM 138,032. OWNCON occurs in 58 percent of the total sample firms. The table shows that politically connected firms accounted for 7 percent of the sample firms and Big 5 auditors audited 66 percent of the sample firms. The total size of the sample firms in terms of market capitalization range

between RM 9,153 and RM 37,763,350. The mean firm size in the sample is RM 2,752,710. The average number of subsidiaries for the total sample is 11.86 percent. The CR varies from 0.04 to 2.10 with a mean of 0.23. MKB shows a significant variation among firms ranging from a minimum of -1.13 to a maximum of 15.67. The mean of number of leveraged firms are 0.67 percent. The foreign subsidiaries vary from 0 -23 with a mean of 1.18. The number of firms recording a loss during the year was 28 percent. There are 57 percent of the samples have a December 31 year end.

Table 1. Descriptive Statistics for all Variables (N = 162)

Variables	Mean	Median	Standard Deviation	Minimum	Maximum
AUDIT FEES	138.32	100.00	120.442	8.00	746.00
INDAC	0.64	0.67	0.134	0.25	1.00
PC	0.07	0.00	0.263	0.00	1.00
OWNCON	0.58	0.59	0.170	0.10	1.00
AUD	0.66	1.00	0.474	0.00	1.00
FSIZE	275271.48	133119.00	586588.00	9153.00	3776335.00
SUBS	11.86	8.5	10.48	0.00	55.00
CR	2.03	1.42	2.46	0.04	2.10
MKB	1.09	0.81	1.42	-1.13	15.67
LEV	0.67	0.24	2.78	-0.63	2.66
LOSS	0.28	0.00	0.452	0.00	1.00
YE	0.57	1.00	0.497	0.00	1.00
FORS	1.18	0.00	2.67	0.00	23.00

where: AUDITFEE = Audit Fees in RM,000, PC = Indicator variable, 1 for politically connected firms, INDAC = Proportion of independent directors on the Audit Committee, OWNCON = Percentage of shares owned by 10 largest shareholders to total number of shares share, AUD = Firms audited by big 5 audit firms, FSIZE = Market Capitalization in RM,000, SUBS = Number of subsidiary companies, CR = Current assets divided by current liabilities, MKB = Market price per share divided by the book value per share, LEV = Non-current liabilities divided by total Equity, LOSS = Indicator variable, 1 for loss making firms, YE = Indicator variable, 1 for fiscal year ending 31 December, FORS = Number of foreign subsidiaries.

Table 2 reports on correlations matrix between all the relevant variables. The results show that audit fees are significantly and positively correlated with the concentration of share ownership, size of the firm

and the number of subsidiaries and foreign subsidiaries that the firm has ($p < 0.01$). Audit fees are significantly and negatively correlated with the

politically connected firms ($p < 0.01$), and the current ratio ($p < 0.05$).

Table 2. Pearson Correlation Coefficients between Variables

	AUFEE	OWNCON	INDAC	PC	AUDIT	FSIZE	SUBS	CR	MKB	LEV	LOSS	YE	FOR
AUFE	1.000												
OWNCON	-	1.000											
INDAC	0.288		1.000										
PC	0.045	-0.001		1.000									
AUDIT	-	-	0.02	0.02	1.000								
FSIZE	0.225	0.292*	0.009	0.15		1.000							
SUBS	0.008	0.043	0.11	0.24	1.177		1.000						
CR	0.324	-	-	-	-	-	-	1.000					
MKB	-	-	-	-	-	-	-	-	1.000				
LEV	-	0.000	-	-	-	-	-	-	-	1.000			
LOSS	-	0.061	-	-	-	-	-	-	-	-	1.000		
YE	-	-	-	-	-	-	-	-	-	-	-	1.000	
FOR	-	-0.005	-	-	-	-	-	-	-	-	-	-	1.000

*** Correlation is significant at the 0.01 level (two-tailed), ** Correlation is significant at the 0.05 level (two-tailed), *Correlation is significant at the 0.1 level (two-tailed)

where: AUDITFEE = Audit Fees in RM,000, PC = Indicator variable, 1 for politically connected firms, INDAC = Proportion of independent directors on the Audit Committee, OWNCON = Percentage of shares owned by 10 largest shareholders to total number of shares share, AUD = Firms audited by big 5 audit firms, FSIZE = Market Capitalization in RM,000, SUBS = Number of subsidiary companies, CR = Current assets divided by current liabilities, MKB = Market price per share divided by the book value per share, LEV = Non-current liabilities divided by total Equity, LOSS = Indicator variable, 1 for loss making firms, YE = Indicator variable, 1 for fiscal year ending 31 December, FORS = Number of foreign subsidiaries.

4.2 Multivariate statistics

Table 3 reports on the multiple regression results testing the association between ownership concentration, politically connected firms and audit fees. Additionally, whether the association between audit fees and politically connected firms demands higher audit fees with the presence strong audit committee. The coefficient for OWNCON is negative and significant at $p < 0.05$ (one-tailed). This result supports our first hypothesis that there would be a negative association between OWNCON and audit fees. Highly concentrated share ownership firms are able to influence and monitor management. Large shareholders have the ability to monitor managers' activities because of their significant economic stakes (Shleifer and Vishny, 1986), assessed by audit firms as having lower inherent risk. Niemi (2005) argued that the information asymmetry between the owners and managers should be lower than other forms of ownership. This reduces the demand for audit and assurance services and leads to a reduction in the audit fee charged.

The coefficient for PC, our variable representing firms that are politically connected firms is negatively and significant at $p < 0.05$. This result supports our second hypothesis that there would be a negative association between politically connected firms and

audit fees. This finding is consistent with prior research by Gul (2006) that highly politically connected firms are negatively associated with audit fees after the imposition of capital control. Our study implies that politically connected firms are generally perceived to have lower inherent risk and lead to lower audit fee after the imposition capital control measure in 1998. The coefficient for the interaction term of the presence of political connection and the proportion of independent directors on the audit committee, PC*INDAC, is positive and significant ($p < 0.05$). This result supports our third hypothesis that higher proportions of independent directors on the audit committee of politically connected firms demand the auditor to put additional effort on the politically connected firm as they were perceived to be risky firms prior to introduction of capital control measure (Gul, 2006). This increases the extent of audit work performed that leads to an increment in the audit fee charged.

Table 3. Multiple Regression Results for Ownership concentration, political connection and audit fees.

Explanatory Variable	Predicted sign	Coefficient β	Beta t - values	Significance
Intercept	?		-0.476	0.635
OWNCON	-	-0.172	-2.471	0.015**
INDAC	-/+	-0.070	-1.093	0.276
PC	-	-1.452	-1.904	0.041**
PC*INDAC	+	1.449	1.908	0.043**
AUD	+	0.010	0.147	0.884
FSIZE	+	0.488	6.500	0.000***
SUBS	+	0.350	5.118	0.000***
CR	+	-0.107	-1.663	0.098*
MKB	-	-0.171	-2.070	0.040**
LEV	+	0.147	1.812	0.072*
LOSS	+	0.162	2.204	0.029**
YE	+	0.119	1.837	0.068*
FORS	+	0.027	0.416	0.678
R^2		0.431		
Adjusted R^2		0.385		
F		9.348		
Durbin Watson test		2.152		
N = 162				

***significant at the 0.01 level (two-tailed), **significant at the 0.05 level (two-tailed), * Significant at the 0.1 level (two-tailed)

where: AUDITFEE = Audit Fees in RM,000, PC = Indicator variable, 1 for politically connected firms, INDAC = Proportion of independent directors on the Audit Committee, OWNCON = Percentage of shares owned by 10 largest shareholders to total number of shares share, AUD = Firms audited by big 5 audit firms, FSIZE = Market Capitalization in RM,000, SUBS = Number of subsidiary companies, CR = Current assets divided by current liabilities, MKB = Market price per share divided by the book value per share, LEV = Non-current liabilities divided by total Equity, LOSS = Indicator variable, 1 for loss making firms, YE = Indicator variable, 1 for fiscal year ending 31 December, FORS = Number of foreign subsidiaries.

The control variables, FSIZE and SUBS positively and significantly associated with audit fees at ($p < 0.01$). LOSS is positively and significantly associated with audit fees at ($p < 0.05$). This result is reasonable given that loss making firms are expectedly a higher concern to auditors in their consideration as to whether the firm will continue as a going concern, leading to higher audit effort being performed and a higher audit fee being charged. Additionally, YE and LEV are positively associated with audit fee and significant at ($p < 0.1$). The coefficient for the current ratio is negative and significant. This result indicates that firms with higher levels of liquidity are perceived by an auditor to have lower inherent risk. The control variable results are with the expected sign and are in line with previous studies. The adjusted R^2 of this study reported 38.5 percent as an explanatory power of the model.

5. Conclusion

We examine the association between ownership concentration, political connection and audit fees. We argue that ownership concentration and politically connected firms influence the extent of audit fees. Examining this issue is very important especially in the context of Malaysia since many companies have very high share ownership concentration and a large

number of companies are politically connected. We use agency theory to explain the relationship between ownership concentration and audit fees. Since concentrated shareholders can monitor management and firms' activities, auditors require spending lesser audit effort that reduces audit fees. It has also been argued that auditors seem to have higher audit fees for politically connected firms because they appear to be associated with corporate failure and misstatement of financial statements. However, audit fees seem to be lower after the imposition of capital controls.

We test whether the presence of effective audit committee on politically connected firms lower the audit fees. We employed cross-sectional regression analysis and observe that highly concentrated ownership firms are able to influence management monitoring reduce the audit fees. This result is consistent with Mitra and Cready (2005). Our findings also suggest that audit fess is negatively associated with politically connected firms which are consistent with Gul (2006). It has also been found that the presence of effective audit committee of politically connected firms demand the auditor to put additional efforts on the politically connected firms which leads to an increment in the audit fee charged.

Our results also indicate that higher ownership concentration is considered to be an important mechanism for the effective corporate governance

system of a firm that reduces the audit fees. Furthermore, our result signifies that audit fees with politically connected firm seem to be lower but this can be higher with the imposition of effective regulatory mechanisms. This implies that regulators should encourage companies to form an effective audit committee for high quality audit services to ensure that firm is able to minimize the risk exposure.

The study is not without its limitations. Our study focuses only from the demand-side perspective, hence, future research can be conducted from the supply-side perspective. Also we use proxy for politically connected firm using companies disclosed by Johnson and Mitton (2002). Future researcher can use different proxies for political connection such as golden shares for Malaysian firms.

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