THE IMPACT OF BOARD COMPOSITION, OWNERSHIP AND CEO DUALITY ON AUDIT QUALITY: THE MALAYSIAN EVIDENCE

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Abstract

Corporate governance is an important element in monitoring the process of financial reporting system. There are three monitoring mechanisms that are theoretically used to ensure the credibility of corporate governance, namely, external auditor, an internal auditing and the directorships. The trends of corporate governance model in developed countries cannot explain the reality of monitoring process of financial reporting in developing countries especially in Asian countries like Malaysia. Therefore, it is important to know to what extent the corporate governance of the Malaysian listed companies has been effective in meeting the responsibility of monitoring the process of financial reporting system? Generally, this study intended to examine an effective component of corporate governance in a Malaysian listed companies and relationship with the audit quality. A total of 655 companies were selected as the sample representing 73.84% of total number of companies across industries in year 2003. The analysis of logistic regression was used to investigate the relationship between dependent and independent variables. Results show that two independent variables had a significant relationship with audit firm size. They were board independence and non-financial institutional ownership. The executive directors’ ownership and CEO/chairman had a negative relationship but not significant with audit quality. Whereas non-executive directors’ ownership and financial institutional ownership showed a positive relationship with audit quality however, it was not significant. The findings posit that both board independence and institutional ownership are important factors to the companies listed at Bursa Malaysia perform effectively. These two elements will improve the decision making process to be more transparent and objective and enhance the independence in selecting quality of external auditor. This study suggests that companies tend to audit by Big 4 if the level of board independence and institutional ownership increase. So, these criteria should be taken seriously by companies’ top management as well as
regulator in order to increase the audit quality and then the quality of financial reporting.

**Keywords:** corporate governance, board independent, directors’ ownership, institutional ownership, CEO duality, big 4, audit quality

**Introduction**

In recent years, increasing attention has been paid to the quality of corporate financial reporting by regulatory authorities as there were series of audit failures among corporate companies. This has led to undermined investors’ confidence in the quality and reliability of the corporate financial systems. Apart from that, the collapse of several large companies in the United State such as Enron, Arthur Andersen and WorldCom, Pramalat in Italy caused by alleged financial statements fraud has created the awareness for the need of producing a quality of corporate financial reporting. An important monitoring of the financial reporting process is the statutory audit whose objective is to provide independent verification of the financial statements prepared by management. Thus, the quality and reliability of published audited financial statements are essential elements to regain the investors’ confidence. These essential elements have given rise to the importance of corporate governance to be given its due role.

The quality of an audit effect the likelihood an auditor will discover material misstatement and report it in the client’s accounting system (DeAngelo, 1981). Therefore, the higher of audit quality will increase a greater chance to detect of any misstatements in the client’s financial reporting. If the quality of an audit is high, then shareholders gain access to information that is more useful. This, in turn, reduces information asymmetry in the capital market. Past studies found that an audit quality had a significant relationship with several components of corporate governance (O’Sullivan, 2000; Beasly and Petroni, 2001; Kane and Velury, 2002; Carcello, Hermanson, Neal and Riley, 2002; Salleh, Stewart and Manson, 2006; Yatim, Kent and Clarkson, 2006; Mitra, Hossain and Deis, 2007). The components were independent of the board of directors as well as independent of the audit committee, non-executive directors’ ownership and institutional ownership. Fama (1980) and Fama and Jensen (1983) argued that the board of directors performed the important function of monitoring the actions of top management.

Most of the previous studies related to corporate governance mechanism and audit quality as well as financial reporting quality concentrated on developed countries. Developing countries, like Malaysia has different corporate governance models and corporate culture that may be lead to the different influences on audit quality. In addition the Asian of financial crisis occurred in 1997-98 shows that majority of big companies among Asian countries did not have strong corporate governance because they could not survive well during that crisis. Therefore, that is very important to examine to what extent the corporate governance of Malaysian companies has been effective in meeting the responsibility of monitoring the process of financial reporting system? To meet this question, this study list several objectives.
Generally, this study intended to examine the effective components of corporate governance in Malaysia listed companies and its relationship with the audit quality. Thus, the objectives of the study were mainly a) to identify the board composition among Malaysian listed companies, b) to determine the structure of board ownership and institutional ownership in the listed companies, c) to determine the structure of the existence of CEO Chairman (CEO duality) among Malaysian listed companies and lastly d) to examine the relationship between board composition, board ownership, institutional ownership and CEO duality on audit quality.

Corporate Governance Mechanism and Audit Quality

The key elements of the accountability framework for corporation are financial reporting, non-executive directors and audit (Spira, 2001). An efficient corporate governance mechanism and audit quality are two important elements to the company especially for the group of big companies in order to ensure the credibility of internal control and monitoring of financial reporting system. Both components complement each other and it is expected to have a close relationship. Good corporate governance mechanism are attempted to acquire a high quality of audit services for the company. Similarly to the quality auditors where they are assumed to constantly improve the quality of corporate governance mechanism of their clients. The agency theory has been used to explain the demand for effective corporate governance mechanism and audit quality.

Audit quality is an important element to ensure the credibility of corporate governance as well as financial reporting process. It is a broader concept and in a very subjective definition. Some studies (O’Sullivan, 2000; Carcello et. al., 2002; Salleh et. al., 2006; Yatim et. al., 2006; Mitra et. al., 2007) use the amount of audit fees to measure audit quality. High amount of audit fees indicate that auditors provide more and efficient audit services compared to low audit fees. However some researchers (DeAngelo, 1981; Palmrose, 1986; Palmrose, 1987; Knapp, 1991; Colbert and Murray, 1998; Beasley and Petroni, 2001) argued that the big size of audit firm especially Big Eight firm as the best indicator to audit quality because this category of audit firm provided higher audit quality than the smaller audit firm.

This category of firms normally has more audit expertise, efficient and effective audit team and more experiences collected from around the world in terms of providing audit services. Higher audit fees among Big Eight firm is found closely related. Palmrose (1986) documented that there is a statistically significant association between auditor size and audit fees based on a Big Eight/non-Big Eight dichotomy. The results support the argument that the Big Eight designation is a quality surrogate, in that increased hours by Big Eight auditors would reflect greater productive activities (evidence acquisition) in providing higher levels of assurance (higher quality) to clients.
Literature Review and Hypotheses Development

Before 1990s the importance of corporate governance was ignored by most of the top management around the world. However, since the series of corporate collapses occurred in early 2000s in developed and developing countries, researchers as well as academicians have been very interested to discover and explore an internal and external mechanism of corporate governance and their contributions to the company. The weakness of corporate governance is the main and important factor blamed for the corporate failure consequences from the economics and corporate crisis. There is much that can be done to improve the integrity of financial reporting through greater accountability, the restoration of resources devoted to audit function, and better corporate governance policies (Saudagaran, 2003).

Among the important internal corporate governance mechanisms emphasized by previous researchers are board composition (O’Sullivan, 2000; Beasley and Petroni, 2001; Salleh et. al., 2006; Yatim et. al., 2006), ownership by directors and outside investors, ownership by financial institutional and non-institutional (O’Sullivan, 2000; Kane and Velury, 2002; Mitra et. al., 2007), and CEO/Chairman (O’Sullivan, 2000; Salleh et. al., 2006). These selected internal mechanisms of corporate governance show a significant relationship with audit quality whether in form of audit size or audit fees. The quality of an external auditor is an effective external mechanism to enhance the quality of corporate governance systems in the company besides the internal mechanism of corporate governance.

Board Independence

Fama and Jensen (1983) have theorized that the board of directors is the best control mechanism to monitor actions of management. They focus board independence based on the agency theory. Outside directors, as representatives of shareholders, have a particularly strong incentive to prevent and detect such opportunities reporting behaviour by management (Fama and Jensen, 1983). This incentive potentially is driven by three factors. Firstly, the directors may seek to protect their reputations as experts in monitoring, because the market for directors punishes those associated with corporate disasters or poor performance.

Secondly, from a legal liability perspective, directors who fail to exercise reasonable care in discharging their monitoring responsibilities are subject to severe sanctions. Thirdly, shareholders often suffer significant losses in the wake of financial reporting problems, so directors seeking to protect shareholder wealth may seek differentially higher-quality audit services (Carcello et. al., 2002). Therefore, outside directors are expected to be more concerned with audit quality than executive directors, who face greater conflicts of interest. Beasley and Petroni (2001) argue that boards with higher percentage of outside directors will seek higher quality auditors in order to provide more effective monitoring of corporate management.
Past study (O’Sullivan, 2000; Salleh et. al., 2006) found that the proportion of non-executive directors had a significant positive impact on audit quality. They suggested that non-executive directors encouraged more intensive audits as a complement to their own monitoring role while the reduction in agency costs expected through significant managerial ownership resulted in a reduced need for intensive auditing. In addition, Jensen and Meckling (1976) highlight that auditing is also one method of ensuring that managers will act in the best interest of the outside shareholders. This argument led to the following hypothesis.

**H1:** There is a significant positive relationship between board independence and audit quality.

**Directors’ Ownership**

Directors are encouraged to have their own portion of ownership in the corporation. This portion ownership is important to the company because it will be expected to have influence on audit quality. However, executive and non-executive directors’ ownership is expected to have different impact on audit quality. Jensen and Meckling (1976) argue that agency conflicts between managers and shareholders may be reconciled when managers possess an ownership interest in their companies. The rationale to invite directors especially non-executive to have a portion of ownership in the corporation is to reduce a gap between director’s interest and the interest of shareholders as well as the corporation. It is hope then the interest of both parties can be aligned. Byrd and Hickman (1992) found evidence that shareholders got benefits when managers and independent outside directors owned at least a small fraction of the bidding firm’s common stock.

In Jensen and Meckling’s (1976) convergence of the interest model, an increase in the proportion of the firm’s equity owned by insider is expected to increase firm value as the interests of inside and external shareholders are realigned. However, when managers own a significant portion of equity they have less incentive to issue misleading information to shareholders so auditors are less likely to need undertake additional testing (O’Sullivan, 2000). He found that audit quality was negatively related to the proportion of equity owned by executive directors. Mitra et al. (2007) also documented that managerial stock ownership was negatively associated with audit fees. Based on the above discussion the following hypotheses were developed.

**H2:** There is a significant positive relationship between non-executive directors’ ownership and audit quality.

**H3:** There is a significant negative relationship between executive directors’ ownership and audit quality.

**Institutional Ownership**

In contrast to the directors’ ownership, an institutional ownership is an investment from a group of outside investor or investment from a certain institution. The percentage of
ownership from institution is normally higher than individual investor. It is assumed that institutional investors have more influence than other individual investor. With the high portion of ownership, institutional ownership has the important of monitoring role in the process auditing. It is rational that institutional investors demand high quality information from the company.

Kane and Velury (2002) observe that the greater the level of institutional ownership, the more likely it is that a firm purchases audit services from large audit firm in order to ensure high audit quality. For the purpose of the study, institutional ownership can be separated into two main categories which are financial institutional and non-financial institutional ownership. The main difference between both groups is related to core business of investor. The core business of financial institutions is investment but not for non-financial institutions. However, both institutions are expected not to have different influence on audit quality.

Mitra et. al. (2007) found that diffused institutional ownership was significantly and positively related to audit fees. They attribute this finding to either institutional investor demand for the purchase of high quality audit services as safeguard against fraudulent financial reporting or firms’ endeavor to purchase high quality audits to attract institutional investment in common stock. It is expected that the portion of institutional ownership will have impact on audit quality of the company. Therefore, the following hypotheses were developed:

\[ H_4: \] There is a significant positive relationship between non-financial institutional ownership and audit quality.

\[ H_5: \] There is a significant positive relationship between financial institutional ownership and audit quality.

**CEO Duality**

This study also intended to discover the relationship between the CEO duality and audit quality. The CEO duality refers to non-separation of roles between CEO and the chairman of the board. In the normal situation, boards with CEO duality are perceived ineffective because a conflict of interest may arise. This characteristic of corporate governance is normal in Malaysian situation. It may be because of the nature of family own business in developing countries like Malaysia. It shows that big sizes of companies that separate person for the both functions normally trade at the higher price to book multiplies (Yermack, 1996) and have higher return on assets and cost efficiency ratios (Pi and Timme, 1993).

According to the Malaysian Code on Corporate Governance (2000) best practice, Malaysian companies are recommended to split the function of CEO and the Chairman of the board to ensure a balance of power and authority, such that no one individual has unfettered power in decision making. It is expected that in the presence of a dominant CEO duality, the company intends to reduce the effort to acquire quality auditor. It hopes that corporate governance is better without CEO duality in the corporation. This practice is also recommended by other codes of corporate governance, including those available
in developed countries. Some studies (O’Sullivan, 2000; Salleh et al., 2006) did not show significant evidence on the relationship between CEO duality and audit fees. This study expected that there was a negative relationship between both variables through the following hypothesis:

\[ H_6: \text{There is a significant negative relationship between CEO duality and audit quality.} \]

**Methodology**

**Sample and Data Collection**

This study used the secondary data as the main source of information analysis. The information relating to the composition of outside director members of board, composition of outside director members of audit committee, directors’ ownership for executive and non-executive director, institutional ownership for financial and non-financial institution, CEO duality, size of audit firm, total assets, total accounts receivable, total inventory and total debts were collected from company annual reports.

A total of 655 companies were selected as sample representing 73.84% of total number of companies across industries that are listed both on the Main Board and Second Board in year 2003. Table 1 summarizes the distribution of sample by industry and audit firm size.

**Table 1: Distribution of sample by Industry and Audit Firm Size**

<table>
<thead>
<tr>
<th>Industry</th>
<th>Big 4 No</th>
<th>Big 4 %</th>
<th>Non-Big 4 No</th>
<th>Non-Big 4 %</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Products</td>
<td>62</td>
<td>55.36</td>
<td>50</td>
<td>44.64</td>
<td>112</td>
</tr>
<tr>
<td>Industrial Products</td>
<td>123</td>
<td>61.81</td>
<td>76</td>
<td>38.19</td>
<td>199</td>
</tr>
<tr>
<td>Trading/Services</td>
<td>94</td>
<td>64.38</td>
<td>52</td>
<td>35.62</td>
<td>146</td>
</tr>
<tr>
<td>Construction</td>
<td>24</td>
<td>51.06</td>
<td>23</td>
<td>48.94</td>
<td>47</td>
</tr>
<tr>
<td>Property</td>
<td>52</td>
<td>65.00</td>
<td>28</td>
<td>35.00</td>
<td>80</td>
</tr>
<tr>
<td>Plantation</td>
<td>35</td>
<td>92.11</td>
<td>3</td>
<td>7.89</td>
<td>38</td>
</tr>
<tr>
<td>Technology</td>
<td>11</td>
<td>57.89</td>
<td>8</td>
<td>42.11</td>
<td>19</td>
</tr>
<tr>
<td>Mining</td>
<td>6</td>
<td>100.00</td>
<td>0</td>
<td>0.00</td>
<td>6</td>
</tr>
<tr>
<td>Infrastruc. Project Com.</td>
<td>7</td>
<td>87.5</td>
<td>1</td>
<td>12.5</td>
<td>8</td>
</tr>
<tr>
<td>Total</td>
<td>414</td>
<td>63.21</td>
<td>214</td>
<td>36.79</td>
<td>655</td>
</tr>
</tbody>
</table>

**Independent Variables**

Six independent variables of the study were board independence, executive directors’ ownership, non-executive directors’ ownership, financial institutional ownership, non-financial institutional ownership and CEO duality where the dependent variable was audit quality, which was measured by size of audit firm. Three independent control variables were also included in the model, they were size of company, business complexity and level of leverage.
Operationalization of Variables

The analysis of logistic regression was used to examine the relationship between dependent and independent variables. The functional form of the logistic regression model is as follows:

\[ \text{Aud}_\text{Quality} = \alpha + \beta_1 \text{Ind}_\text{BOD} + \beta_2 \text{ExDir}_\text{Own} + \beta_3 \text{NexDir}_\text{Own} + \beta_4 \text{FIns}_\text{Own} + \beta_5 \text{NFIns}_\text{Own} + \beta_6 \text{CEO}_\text{Cman} + \beta_7 \text{Size}_\text{Com} + \beta_8 \text{Buss}_\text{Com} + \beta_9 \text{Leverage}_\text{Com} + \epsilon \]

The definition and operationalization of dependent variable, independent variables and control variables were based on the following manner. The dichotomous dependent variable, audit quality was set equal to one if the company audited by Big 4 audit firm, otherwise, zero (Kane and Velury, 2002). Big 4 audit firms were assumed to have quality of audit services compared to non-Big 4 audit firm.

There were six independent variables includes in the above model. The following measures were based on the previous studies (O’Sullivan, 2000; Beasley and Petroni; Carcello et al., 2002; Salleh et al., 2006; Yatim et al., 2006; Mitra et al., 2007). Board independence was measured through the composition of non-executive in board of directors (BOD) in form of percentage. The non-executive and executive directors’ ownership depended on the percentage of shares owned. Similarly, the portions of ownership by non-financial and financial institution were calculated through the percentage shares owned. The variable of CEO Chairman was a dichotomous variable that operated as one if the company has CEO and also Chairman, otherwise, zero.

There were three control variables included in this research model namely, size, business complexity and leverage of company. The variables were found to have significant relationships with the audit quality (Kane and Velury, 2002). However, it was not the objective of this study to examine these variables. The size of the company was measured by the total assets owned in Ringgit Malaysia (RM) whereby the business complexity was measured equal to \((\text{total accounts receivable} + \text{total inventory})/\text{total assets}\) and lastly the company leverage was equal to total debts divided by total assets (Kane and Velury, 2002).

Results of Analysis

Analysis of Descriptive Statistics

Table 2 presents the mean, median and standard deviation for each variable in the study.

The table shows about 63% of the companies audited by Big 4. 78% of audit committee members are non-executive directors compared to board of director members who are non-executive directors, 63%. Ownership by executive directors, 8.7% is higher than ownership by non-executive directors, 2.6%. Non-financial institutional ownership is 44% contrasted to financial institutional ownership is just only 8.2%. Only about 45% of companies have CEO and also as chairman of board of directors.
Analysis of Logistic Regression

The analysis of logistic regression was done to test the hypothesis of H₁, H₂, H₃, H₄, H₅, and H₆. The test of multicollinearity was run before analyzing the logistic regression model. This test used the correlation test of Pearson among independent variables. The results show low coefficient correlations indicating no multicollinearity problems among independent variables except for audit committee independence, which was 0.56. So, audit committee independence was not included in the analysis of logistic regression. Results of the analysis logistic regression are summarized in Table 3.

Table 2: Descriptive Statistics of Variables

<table>
<thead>
<tr>
<th>Variables</th>
<th>Mean</th>
<th>Median</th>
<th>Std. Dev.</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit firm size</td>
<td>0.6321</td>
<td>1.0000</td>
<td>0.4826</td>
<td>0.0000</td>
<td>1.0000</td>
</tr>
<tr>
<td>Board independence</td>
<td>0.6325</td>
<td>0.6250</td>
<td>0.1892</td>
<td>0.0000</td>
<td>1.0000</td>
</tr>
<tr>
<td>Audit committee independence</td>
<td>0.7814</td>
<td>0.7500</td>
<td>0.1573</td>
<td>0.0000</td>
<td>1.0000</td>
</tr>
<tr>
<td>Executive directors’ ownership</td>
<td>8.766E-02</td>
<td>7.200E-03</td>
<td>0.1425</td>
<td>0.0000</td>
<td>0.7075</td>
</tr>
<tr>
<td>Non-executive directors’ ownership</td>
<td>2.683E-02</td>
<td>4.000E-04</td>
<td>6.990E-02</td>
<td>0.0000</td>
<td>0.5511</td>
</tr>
<tr>
<td>Financial institutional ownership</td>
<td>8.248E-02</td>
<td>3.430E-02</td>
<td>0.1305</td>
<td>0.0000</td>
<td>0.8094</td>
</tr>
<tr>
<td>Non-financial institutional ownership</td>
<td>0.4454</td>
<td>0.4639</td>
<td>0.1936</td>
<td>0.0000</td>
<td>0.8855</td>
</tr>
<tr>
<td>CEO and chairman</td>
<td>0.4595</td>
<td>0.0000</td>
<td>0.4987</td>
<td>0.0000</td>
<td>1.0000</td>
</tr>
</tbody>
</table>

Table 3: Results of Analysis Logistic Regression

<table>
<thead>
<tr>
<th>Independence Variables</th>
<th>Expected direction of relationship</th>
<th>Estimated parameters</th>
<th>Wald $\chi^2$</th>
<th>Value of p</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>+</td>
<td>-1.516</td>
<td>14.282</td>
<td>0.000</td>
</tr>
<tr>
<td>Board independence</td>
<td>+</td>
<td>1.586</td>
<td>8.665</td>
<td>0.003*</td>
</tr>
<tr>
<td>Exe ownership</td>
<td>-</td>
<td>-0.490</td>
<td>0.428</td>
<td></td>
</tr>
<tr>
<td>Non-exe ownership</td>
<td>+</td>
<td>0.326</td>
<td>0.798</td>
<td></td>
</tr>
<tr>
<td>Fin ownership</td>
<td>+</td>
<td>1.518</td>
<td>0.064</td>
<td></td>
</tr>
<tr>
<td>Non-fin ownership</td>
<td>+</td>
<td>1.240</td>
<td>0.013*</td>
<td></td>
</tr>
<tr>
<td>CEO and chairman</td>
<td>-</td>
<td>0.053</td>
<td>0.774</td>
<td></td>
</tr>
<tr>
<td>Size</td>
<td>+</td>
<td>0.000</td>
<td>0.042*</td>
<td></td>
</tr>
<tr>
<td>Business complexity</td>
<td>+</td>
<td>1.942</td>
<td>0.000*</td>
<td></td>
</tr>
<tr>
<td>Leverage</td>
<td>+</td>
<td>-0.010</td>
<td>0.978</td>
<td></td>
</tr>
<tr>
<td>Cox &amp; Snell R²</td>
<td></td>
<td>0.87</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nagelkerke R²</td>
<td></td>
<td>0.119</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No. of companies Big 4 audit firm</td>
<td></td>
<td>414</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No. of companies not using Big 4 audit firm</td>
<td></td>
<td>241</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total sample</td>
<td></td>
<td>655</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The above table shows the value of Nagelkerke $R^2$ is 0.119 and Cox & Snell $R^2$ is 0.87. Results show that two independent variables namely board independence and non-financial institutional ownership had a significant relationship with audit firm size. Board independence had a significant positive relationship with the audit firm size at $p=0.003$. This finding supports H1. It means that the higher level of board independence will increase the tendency of selecting Big 4 by companies as an auditor.

Therefore, we can conclude that the board independence has a potential element to increase the quality of auditing for companies. This result is consistent with studies of O’sullivan (2000); Beasley and Petroni (2001); Carcello et al. (2002) and Salleh et al. (2006) which is indicates that the proportion of non-executive directors has a significant positive impact on audit quality.

The study also finds that non-financial institutional ownership is significantly related to the audit firm size at $p=0.013$. This findings support H4. Its means that the higher level of ownership by non-financial institution will increase the tendency of companies choose Big 4 as their external auditor. The results support the findings by Kane and Velury (2002)’s and Mitra et al. (2007)’s studies.

The executive directors’ ownership had a negative relationship but was not significant with audit quality. The value of estimated parameters was $-0.490$. Hence, this finding did not support H3. It is consistent with the study by O’Sullivan (2000) and Mitra et al. (2007) who found that audit quality was negatively related to the proportion of equity owned by executive directors.

Results for independent variables such as, non-executive directors’ ownership, financial institutional ownership showed a positive relationship but it was not significant with audit quality. The CEO chairman showed a negative relationship with audit quality. So, these results did not support H2, H5 and H6. However, these three variables still showed correlation with the quality of audit. May be the limitation of the study influenced the result found.

**Discussions and Conclusions**

The main objective of the study was to examine the selected qualities of corporate governance mechanism in influencing the audit quality of the company. Specifically, this study concentrated on independence directors, executive directors and non-executive directors’ ownership, financial and non-financial institutional ownership and CEO duality. Each variable was expected to have influence on audit quality whether positively or negatively related and then six hypotheses were developed in order to test each variable. The previous discussion shows the analysis of results for each of these hypotheses.

The findings show that both board independence and institutional ownership are two important factors that could assist companies listed at Bursa Malaysia to perform effectively. These two elements will improve the decision making process to be more
independent, transparent and objective especially in selecting an external auditor. Evidence from this study shows that the company tends to audit by Big 4 if the level of board independence and institutional ownership increase. So, these criteria should be taken seriously by companies’ top management in order to increase the audit quality and subsequently the quality of financial reporting.

Even though another four variables of executive director and non-executive director ownership, financial institutional ownership and CEO/Chairman were not found to be significant, these variables still have a correlation to audit quality at certain levels. This finding warrants more investigation through the addition of other variables or through a change of the combination of variables. The regulators and management of the company have not ignored these variables in improving the rules and regulations related to form effective corporate governance as well as effective management.

Based on the findings of this study, we recommend that (i) the composition of non-executive directors in board of directors should be increased in order to increase the level of board independence to more than 80%; (ii) institutional ownership especially from non-financial institution should be encouraged in order to maintain the quality of financial reporting; (iii) the ownership by executive directors’ should decrease to a minimum level because of a negative relationship existing between executive directors’ ownership and audit quality; and lastly (iv) the functions of the CEO and the Chairman should be segregated to different officers in order to increase the efficiency of internal control system.

References


