Audit Committee and Audit Fees in Malaysia: The Moderating Role of Political Connection

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Abstract

The Malaysian corporate governance regime underwent significant enhancement through the revamp of the Bursa Malaysia Listing Requirements (BMLR) in 2008 in respect of audit committee characteristics in order to address adverse market perceptions of its relationship based economy with the strong presence of politically connected (PCON) firms. This study investigates whether such reforms have made a difference. We examine if PCON firms have higher audit fees post implementation of BMLR 2008 on audit committee characteristics. Using data from 945 firm-year observations for 2005 to 2009 we find that PCON firms have higher audit fees due to improved governance which demands an increase in audit effort.

Further, the association between audit committee independence, diligence, and expertise and audit fee is stronger post-2008, suggesting that PCON firms are committed to strong corporate governance and are prepared to pay a higher quality external audit work.

Keywords: Audit Committee, Audit Fees, Corporate Governance, Political Connections, Political Embeddedness Perspective
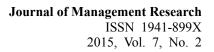
1. Introduction

There is consensus in the extant literature that politically connected (PCON) firms differ from non- politically connected (non-PCON) firms in terms of performance, leverage access to financing, costs of capital and market perception of risk (Faccio, 2010; Bliss and Gul, 2012a). However, there is limited empirical evidence on the impact of corporate governance reforms between these two groups. The 1997 Asian financial crisis fuelled severe criticisms regarding the Malaysian "relationship-based" economy evidenced by the existence of PCON firms (Bliss and Gul, 2012b). PCON firms were perceived by the market as being inefficient and that the government was unlikely to be able to support these favoured firms (Johnson and Mitton, 2003).In order to enhance corporate governance, Malaysia introduced its Code of Corporate Governance in 2000, which was revised in 2007 and 2012. In line with the revised Code of 2007, the Bursa Malaysia Listing Requirements (BMLR) was also revised in 2008. The reforms called for among others, a greater role for the gatekeepers of the capital market - the audit and assurance professionals (Ghosh and Moon, 2005). Furthermore, the government took proactive steps to dispel the negative perceptions of its government-linked firms (in this paper collectively referred to as PCON firms). Khazanah, the government's investment arm, introduced measures to enhance board effectiveness by revamping board practices and processes (Khazanah's Green Book, 2006). The impact of these efforts on audit fees has not been examined in prior studies as these studies on audit fees were conducted prior to BMLR 2008.

Further, such studies on auditors focused on auditor tenure, audit quality and audit fees (Ghosh and Moon, 2005; Abdul Wahab *et al.,* 2009, 2011). Whilst there is consensus in the extant literature that PCON firms differ from non-PCON firms in terms of market and auditor perceptions of risk and performance (Faccio, 2010), there is limited empirical evidence on the impact of corporate governance reforms between these two groups and the association with audit fees. In adopting the political embeddedness perspective, this study takes cognizant of the unique Malaysian political economy to achieve their mutual objectives since such favoured firms play an important role in the corporate setting. Hence, this study extends the audit fee literature to examine the relation between audit fees and the enhanced internal governance mechanisms, specifically, audit committee independence, diligence and expertise amongst PCON and non-PCON firms in Malaysia. As PCON firms are generally perceived to exhibit poor corporate governance, greater agency problems (Abdul Wahab *et al.,* 2009) and more risk (Gul, 2006), this study examines whether PCON firms have higher audit fees post implementation of BMLR 2008. Prior studies on PCON firms have generally drawn on the supply based perspective, and we argue that if corporate governance had been effectively implemented, the demand side explanation should prevail. Therefore, we investigate the impact of audit committee characteristics post BMLR 2008 implementation.

The remainder of this paper is structured as follows. The next section explains the literature review and hypotheses development section. The third section describes the research design while the results and discussions are reported in the fourth section. The final section presents conclusions of the study.

2. Literature Review and Hypotheses Development

Malaysia has a "relationship-based" economy resulting from the existence of PCON firms (Bliss and Gul, 2012a). These PCON firms have exclusive business relationships with the state-owned enterprises and have the ability to access government's major contracts (Gomez and Jomo, 1999). Most interestingly, not many countries exhibit such corporate phenomenon among their listed firms. It is evidenced that, in the early stages of the Asian Financial Crisis, PCON firms were perceived by the market as being inefficient and that the government was unlikely to be able to support these favoured firms (Johnson and Mitton, 2003). Since PCON firms are perceived to be riskier than non-PCON firms, it is reasonable to expect PCON firms to implement good governance system to improve the compliance level, consequently to protect their reputational capital. The benefits associated with political connections, emphasising that such connections provide opportunities to impact regulatory policies to enhance firms' legitimacy, gain access to valuable state controlled resources, benefit from preferential treatment and receive exclusive information regarding state policies (Okhmatovskiy, 2010). In this context such connections may enhance firms' performance (Luo and Chen, 1997; Peng and Luo, 2000; Fisman, 2001; Johnson and Mitton, 2003).During the pre-2007 period, Gul (2006) find a greater increase in audit fees for PCON firms than for other ownership structured firms, suggesting a supply-side explanation for audit fees. Abdul Wahab *et al.* (2009) find a positive relationship between institutional ownership and audit fees and they too found that the audit fees are higher for PCON firms during the pre-2007 period. No studies have been reported to date on the demand-side explanation ofthe impact of the BMLR 2008 on audit fees for PCON firms

However, as corporate governance reforms are introduced, many new factors enter the equation on audit pricing. From a supply side perspective, external auditors are able to reduce the external audit testing and consequently audit fees if an audit committee serves as a substitute to the external auditors in monitoring the management. However, if the external auditors perceive the audit client firms as having higher audit risk, they are expected to increase audit effort hence leading to higher audit fees. Alternatively, from a demand side perspective, if audit committees complement the work performed by the external auditors, higher audit fees will be charged to the audit client because the audit committee may demand more audit procedures from the external auditor in order to avoid material misstatement in financial reporting. . Based on prior literature for pre-2007 period and the arguments presented above, we propose the following hypothesis:

Hypothesis 1:

PCON firms pay higher audit fees than non-PCON firms.

From an agency theory perspective, effective monitoring of firms' activities is believed to reduce managers' opportunistic behavior. Such behavior arises because shareholders and managers have different attitudes towards risks and such conflicts of interest issue eventually gives rise to agency cost (Arnold and de Lange, 2004). In order to reduce such behavior, monitoring by independent directors is crucial (Abbott *et al.*, 2004; Carcello *et al.*, 2002). Accordingly, it is posited that a higher number of independent directors on audit committee

results in a more effective oversight of the financial reporting process (Bedard and Johnstone, 2004). Whilst the BMLR 2008 has not specifically defined independence, it has emphasized Para 15.10 (b) which requires all audit committee members to be non-executive directors with a majority of them being independent directors, and the chairman of the audit committee be an independent director. Comparatively, prior to BMLR 2008, the requirement was only for a majority of the audit committee members to be independent directors. Since PCON firms are constantly reminded to enhance corporate governance[1], the audit committee is expected to be more independent and to provide superior oversight of the financial reporting process. As a result, the PCON firms require more extensive audit testing and hence higher external audit fees are expected. Therefore, the above argument leads to the following hypothesis:

Hypothesis 2a:

The association between audit committee independence and audit fees is stronger post-BMLR 2008 implementation for PCON than non-PCON firms.

According to the BMLR 2008 Para 15.18 (f), audit committee convenes meetings with the external auditors, the internal auditors or both, without the presence of other directors and employees whenever necessary. This is an improvement from the previous position whereby it was provided that the audit committee could convene meetings with the external auditors, excluding the attendance of the executive members of the committee. Additionally, Paragraph 15.15 of the BMLR 2008 requires the audit committee to meet at least four (4) times in a year or once on a quarterly basis. Abbot *et al*. (2004) called for audit committee to be diligent in carrying out their duties. Yatim *et al*. (2006) found that frequent audit committee meetings can reduce financial reporting problems. Conger *et al.* (1998) and Vafeas and Waegelein (2007) also suggest that board effectiveness depends on the number of meetings held annually. Hence, meeting frequency is often used as a proxy for audit committee diligence (Yatim *et al.,* 2006). Therefore, we predict that a more diligent audit committee would demand substantive audit testing by the external auditor which results in higher audit fees for PCON firms. This is in line with PCON firm's aspirations to improve their performance resulting from market scrutiny and hence the next hypothesis is as follows:

Hypothesis 2b:

The association between audit committee diligence and audit fees is stronger post BMLR 2008 implementation for PCON than non-PCON firms.

As recommended by the Blue Ribbon Committee (BRC) (1999), audit committee members are expected to be financially literate and knowledgeable about technical accounting and auditing matters. In line with the BRC (1999), BMLR 2008 Para 15.13 (e) specifically outlines the audit committee's functions to include the review of the adequacy of the competency of the internal audit function. This further complements the earlier requirement for the audit committee to review the adequacy of the scope, functions and resources of the internal audit function. Additionally, Para 15.16 (3) (e) provides that the audit committee

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[1] Khazanah's Green book objective is to raise the overall effectiveness of Boards

report shall include a summary of the activities of the internal audit function or activity. Prior to BMLR 2008, audit committee was required only to report whether an internal audit function existed and if not, to disclose the reasons. BMLR 2008 Para 15.10 (c) requires at least one member of the audit committee to have financial or accounting related qualification. This requirement also existed in earlier BMLR. This is because auditors are less likely to refer complicated auditing issues to an audit committee if they perceive the audit committee lacks knowledge in technical accounting matters (Cohen *et al.*, 2002). Conversely, a financially literate and knowledgeable audit committee will demand audit quality as they are knowledgeable on technical accounting issues, and hence resulting in an increase in the audit fees.Given the PCON firms motivation to adopt stronger governance practices in line with Khazanah directives (Khazanah's Green Book, 2006), we hypothesize that:

Hypothesis 2c:

The association between audit committee expertise and audit fees is stronger post BMLR 2008 implementation for PCON than non-PCON firms.

3. Research Method

3.1 Data Collection

The sample consists of 945 firm-year observations for 2005 to 2009 that are before and after the revision of the BMLR 2008. Data that are not available from DataStream are hand collected from the annual reports of Malaysian firms listed on the Bursa Malaysia's main board. The pre-test period covers the time frame from 2005 to 2007 and the post-test period covers years 2008 and 2009.

3.1.1 Audit Fee Model

Majority of studies use the natural logarithm of audit fees as the dependent variable in the audit fee model (Francis, 1984). Consistent with previous studies (Francis, 1984; Francis and Simon, 1987) the tests of normality and logarithmic transformation are applied to the audit fee. In this study, audit fee is measured by the value (Ringgit Malaysia) of the audit fee paid by the firm to its auditors. The main experimental variables for this study are the audit committee independence (IND), diligence (DIL), expertise (EXP). Audit fee model used in past studies have included a variety of variables to control for cross-sectional differences associated with client size, complexity and client risk (Simunic, 1980; Craswell, 1992; Gul and Tsui, 1997). The set of control variables selected in this study is consistent with the variables generally identified in much of the literature on audit fees (Hay *et al.*, 2006) and they are as follows. The total assets (TA) are to measure the client size. A positive relationship between firm size and audit fees is predicted since larger firms are more complex and requires more audit effort, hence higher audit fees (Simunic, 1980; Francis, 1984). Non audit fees (NAF) is also included as a control variable because it is significantly associated with audit fees (Whisenant *et al.*, 2003; Hay *et al.*, 2006; Hay, 2012). As to control for audit complexity, the number of local subsidiaries (SUB) and foreign subsidiaries (FOREIGN)are taken into account (Simunic, 1980; Hackenbrack and Knechel, 1997), indicating that more subsidiaries and business segments will lead to greater amount of work and audit hours of

consolidating and eliminating intra-group transactions (Chan *et al*., 1993). The ratio of total liability to total assets (LEV) is used to control for leverage which potentially exposes the auditor to loss if the firm is failing (Simunic, 1980). In addition, a dummy variable for loss-making (LOSS) in any of the years is included and a positive relationship is predicted. A dummy variable for Big4 controls for differences in audit quality (AQ) (Craswell and Francis, 1999;Tsui *et al*., 2001) and it is expected that firms associated with large auditing lead to an increase in audit testing and higher audit qualitypurchase a higher level of audit quality (DeAngelo, 1981;Carcello, 2002). A dummy variable for PCON firms thattakes a value of '1'and '0' for non-PCON firms.

3.1.2 Descriptive Statistics

Descriptive analysis is used to describe the characteristics of the sample and the control sample. Table 1 shows t-tests and chi-square analysis for the continuous and indicator variables in Panels A and B respectively. Panel A represents pre-test period and Panel B represents post-test period sample for PCON and non-PCON firms, with the descriptive of mean, standard deviation and median. The descriptive statistics show that for samples in both periods, PCON firms are bigger in terms of total assets (TA) and have a larger number of local subsidiaries (SUB) and foreign subsidiaries (FOREIGN). The PCON firms also have higher non-audit fees (NAF) and higher audit quality (AQ).In general, PCON firms have higher average audit fees than non-PCON firms in both periods. From the table, it shows that PCON firms pay higher audit fees in comparison with non-PCON firms, thus fully support Hypothesis 1. This indicates that PCON firms demand for substantive audit testing and improve audit quality from external auditors and willing to pay higher audit fees.The descriptive statistics also show that the average audit fees for PCON firms increased from M$598,771.9 during the pre-test period to M$739,045.7 during post-test period. As expected, the sampled firms' audit committee characteristics record significantly higher scores for the post-test period. On average, audit committee independence (IND) increased from 88 percent in pre-test period to 96 percent for post-test period. Additionally, the sample firms have audit committee members that are predominantly diligent (DIL) (pre-test period 5.47 and post-test period 5.63) and having financial or accounting expertise (EXP) (pre-test period 1.37 and post-test period 1.47).Corporate governance generally improves after 2008 especially for PCON firms in comparison with non-PCON firms in terms of audit committee DIL and EXP. It shows that the PCON firms are complying with the newly amended BMLR 2008 on audit committee characteristics. This is consistent with past studies (Abdul Wahab *et al.,* 2011; Chan *et al.,* 1993; Gregory and Collier, 1996; O'Sullivan, 1999 and 2000; Carcello *et al.,* 2002) that document higher audit fees for firms with improved governance, which is in line with the demand side explanation.

Table 1. T-tests and Chi-square Analysis

Panel A Pre-test period (2005 to 2007)

Variable	PCON Firms (N=335)			Non-PCON Firms (N=610)			t-test/Chi-square
	Mean	Std. Dev	Median	Mean	Std. Dev	Median	
LAF	12.40	1.08	12.37	11.60	0.76	11.50	-9.18*
AF	598771.87	1278824.34	241000.00	153624.42	207209.82	99100.00	-4.90*
LTA	14.26	1.50	14.11	12.76	1.17	12.61	-12.140*
TA	5733265.99	12757264.08	1362503.00	846336.84	2134063.15	303302.50	-5.39*
LNAFº	7.06	9.30	10.90	1.14	10.68	8.51	-6.85*
NAF	365415.53	831497.13	54500.00	37732.08	109244.58	5000.00	-5.54*
SUB	32.58	46.66	19.00	24.20	14.25	10.00	-5.44*
FOREIGN	5.12	14.40	0.00	0.41	1.33	0.00	-4.62*
LEV	0.29	0.16	0.25	0.25	0.16	0.23	-2.40
LOSS	0.20	0.40	1.00	0.17	0.37	0.00	©0.42
AQ	0.79	0.40	1.00	0.64	0.48	1.00	©0.00*
IND	0.88	0.15	1.00	0.78	0.16	0.75	-7.00
DIL	5.47	2.14	5.00	4.81	1.04	5.00	-4.13*
EXP	1.37	0.62	1.00	1.37	0.60	1.00	0.11

Panel A: Post-test period (2008 to 2009)

Variable	PCON Firms (N=335)			Non-PCON Firms (N=610)			t-test/Chi-square
	Mean	Std. Dev	Median	Mean	Std. Dev	Median	
LAF	12.63	1.06	12.58	11.80	0.82	11.71	-7.68*
AF	739045.69	1727857.35	301500.00	201468.63	322707.74	121371.00	-3.56*
LTA	14.31	1.51	14.058	12.92	1.19	12.73	-9.07*
TA	5945714.89	11669897.66	1468634.50	1198971.02	3558518.15	341025.50	-4.56*
LNAFº	8.24	8.00	10.81	2.17	10.54	8.85	-6.28*
NAF	461066.97	1324152.27	50000.00	47308.36	171319.76	7000.0	-3.60*
SUB	34.63	49.86	19.00	16.20	16.13	11.00	-4.16*
FOREIGN	5.63	15.28	1.00	0.59	1.64	0.00	-3.81*
LEV	0.28	0.16	0.25	0.25	0.16	0.23	0.09
LOSS	0.21	0.40	0.00	0.18	0.38	0.00	©0.49
AQ	0.79	0.40	1.00	0.62	0.48	1.00	©0.00*
IND	0.96	0.08	1.00	0.97	0.09	1.00	0.27
DIL	5.63	2.33	5.00	5.18	1.67	5.00	-3.88*
EXP	1.470	0.66	1.00	1.42	0.62	1.00	-1.26

$p < 0.05$; © chi-square testºObservations having a zero for LNAF are re-coded to a small positive value (0.00001) to enable a logarithmic transformation.

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non-audit fees (in RM) while LNAF is natural logarithm of non-audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to '1' if the firm has made loss in any of the years, '0' if otherwise; AQ an indicator variable equals to '1' if the firm hires Big4 auditor and '0' if otherwise; IND is the proportion of independent non-executive directors to audit committee; DIL is the number of meetings; EXP is the number of audit committee with accounting or finance qualification.

3.1.3 Model Specification

Drawing from prior literature (i.e. Craswell and Francis, 1999; Tsui *et al.*, 2001; Carcello *et al.*, 2002), the following regression model is run to test H2:

$$LAF = \beta_0 + \beta_1 TA + \beta_2 NAF + \beta_3 SUB + \beta_4 FOREIGN + \beta_5 LEV + \beta_6 AQ + \beta_7 LOSS + \beta_8 PRD + \beta_9 PCON + \beta_{10} IND + \beta_{11} EXP + \beta_{12} DIL + \beta_{13} IND\_PCON + \beta_{14} EXP\_PCON + \beta_{15} DIL\_PCON + \varepsilon,$$

Where:

LAF	=	Audit fee paid by the client (natural logarithm of AF)
Control Variables		
TA	=	Natural logarithm of total assets.
NAF	=	Natural logarithm of non audit fees.
SUB	=	Number of local subsidiaries.
FOREIGN	=	Number of foreign subsidiaries.
LEV	=	Proportion of total liability over total assets.
AQ	=	An indicator variable equals to '1' if Big4 auditor, and '0' if otherwise.
LOSS	=	An indicator variable equals to '1' if the firm has made loss in any of the years and '0' if otherwise.
PRD	=	An indicator variable equals to '1' for post-test period and '0' if otherwise.
PCON	=	An indicator variable equals to '1' for PCON firms and '0' if otherwise.
Experimental Variables		
IND	=	Proportion of independent non-executive directors to AC.
DIL	=	Number of AC meetings.
EXP	=	Number of AC with accounting or finance qualification.
IND_PCON	=	Interaction term between IND and PCON
DIL_PCON	=	Interaction term between DIL and PCON
EXP_PCON	=	Interaction term between EXP and PCON
ε	=	Error term

4. Results and Discussions

Table 2 reports the correlations between the variables used in the regressions for pre-test and post-test periods between audit fees and other variables. From the table, audit committee IND

Table 2. Pearson Correlation Matrix for sample firms (Year 2005 – 2007, n = 945)

	LAF	AF	LTA	TA	LNAF	NAF	SUB	FORGN	LEV	LOSS	AQ	PCON	IND	DIL	EXP
LAF	1	0.809**	0.769**	0.446**	0.315**	0.434**	0.744**	0.469**	0.183**	-0.124**	0.262**	-0.139**	0.089*	0.254**	0.058
AF		1	0.642**	0.421**	0.185**	0.649**	0.888**	0.875**	0.040	-0.074	0.115**	-0.120**	0.076	0.092*	0.098*
LTA			1	0.626**	0.286**	0.440**	0.546**	0.400**	0.190**	-0.134**	0.312**	-0.162**	0.173**	0.283**	0.057
TA				1	0.159**	0.526**	0.378**	0.344**	0.129**	-0.095*	0.124**	-0.113**	0.135**	0.318**	0.047
LNAF					1	0.292**	0.203**	0.151**	0.086*	-0.066	0.211**	-0.163**	0.125**	0.127**	0.038
NAF						1	0.539**	0.596**	0.065	-0.033	0.147**	-0.119**	0.078	0.287**	0.110**
SUB							1	0.819**	0.089*	-0.066	0.116**	-0.139**	0.093*	0.101*	0.103*
FORGN								1	0.020	-0.061	0.104*	-0.106*	0.079	0.000	0.062
SEG									0.049	-0.038	0.016	0.028	-0.020	0.036	0.101*
ROA									-0.065	-0.616**	0.043	-0.042	0.099*	-0.036	0.006
LEV									1	0.107*	0.034	0.102*	-0.088*	0.124**	-0.067
LOSS										1	-0.053	0.048	-0.024	0.001	0.042
AQ											1	-0.047	0.032	0.073	-0.002
PCON												1	-0.087*	-0.115**	-0.031
IND													1	0.125**	0.059
DIL														1	0.086*
EXP															1

Table 2. Pearson Correlation Matrix for sample firms (Year 2008 – 2009, n = 945)

	LAF	AF	LTA	TA	LNAF	NAF	SUB	FORGN	LEV	LOSS	AQ	PCON	IND	DIL	EXP
LAF	1	.805**	0.782**	0.504**	0.318**	0.349**	0.745**	0.481**	0.385**	-0.052	0.272**	-0.114*	0.007	0.252**	0.161**
AF		1	0.630**	0.611**	0.165**	0.616**	0.814**	0.796**	0.264**	-0.050	0.110*	-0.102*	0.047	0.112*	0.185**
LTA			1	0.638**	0.275**	0.384**	0.569**	0.364**	0.240**	-0.103*	0.324**	-0.131*	-0.003	0.264**	0.142**
TA				1	0.132*	0.436**	0.484**	0.400**	0.130*	-0.099	0.139**	-0.084	0.042	0.343**	0.144**
LNAF					1	0.234**	0.204**	0.172**	0.115*	0.003	0.255**	-0.118*	0.056	0.188**	0.145**
NAF						1	0.600**	0.742**	0.218**	-0.022	0.146**	-0.099	0.051	0.160**	0.221**
SUB							1	0.808**	0.382**	-0.063	0.126*	-0.109*	0.031	0.093	0.199**
FORGN								1	0.195**	-0.036	0.112*	-0.102*	0.060	0.039	0.192**
SEG									1	-0.032	-0.014	0.029	-0.061	0.047	0.137**
ROA										-0.596**	0.129*	-0.107*	-0.076	-0.056	0.096
LEV										0.160**	0.030	0.174**	-0.054	0.143**	-0.068
LOSS										1	-0.103*	0.051	0.092	0.060	-0.107*
AQ											1	-0.072	0.043	0.078	0.017
PCON												1	0.081	-0.167**	-0.075
IND													1	0.034	-0.030
DIL														1	0.223**
EXP															1

and DIL have a positive and significant association with audit fees for pre-test period where else DIL and EXP for post-test period. It suggesting that audit committee's IND, DIL and with EXP demand for higher quality audit from external auditors, hence higher audit fees.

The signs for the control variables are all in the right direction and significant in the testing periods except for the coefficient for LOSS and LEV. Significant results in the predicted direction are obtained for the coefficients for TA, NAF, SUB, FOREIGN and AQ. While a few governance variables are significantly correlated with each other, their correlations do not indicate that multicollinearity is a serious problem.

A multiple regression was performed between audit fees (AF) as the dependent variable and audit committee characteristics IND, DIL, and EXP. Results in Models 1 and 2 of Table 3 are significant at one percent significant level (p=0.000), with an adjusted R² of at least 82.4 percent which is comparable with other Malaysian studies in this area (Yatim *et al.,* 2006; Abdul Wahab *et al.,* 2011).

Table 3. Audit fee regression models (n =945)

Variable	Sign	Model 1	Model 2		
			I	II	III
		Coefficient	Coefficient	Coefficient	Coefficient
Constant		31.435	31.072	31.897	31.785
LTA	+	0.416***	0.415***	0.410***	0.411***
TA	+	0.054***	0.056***	0.066***	0.053***
LNAF	+	0.063**	0.061**	0.062**	0.065**
NAF	+	0.080**	0.079**	0.086**	0.071**
SUB	+	0.686**	0.691**	0.700**	0.693**
FOREIGN	+	-0.213**	-0.219***	-0.217***	-0.214***
LEV	-	-0.062**	-0.061**	-0.061**	-0.068***
AQ	+	0.058**	0.057***	0.055***	0.059***
LOSS	+	-0.003	-0.005	-0.008	-0.002
PCON	+	0.040**	0.048	0.141*	0.186***
PRD	+	0.042**	0.046***	0.044***	0.040**
IND	+	0.048***	- 0.062***	-0.045***	-0.046***
DIL	+	0.074***	0.074***	0.004	0.084***
EXP	+	0.025*	- 0.026*	-0.031**	-0.008
IND_PCON	+		0.111*		
DIL_PCON	+			0.215***	
EXP_PCON	+				0.122***
Adj. R²		0.824	0.825	0.827	0.826

Notes: AF is audit fees while LAF is natural logarithm of audit fees; TA is total assets (in RM) while LTA is natural logarithm of total assets; NAF is non-audit fees (in RM) while LNAF is natural logarithm of non-audit fees; SUB is number of subsidiaries; FOREIGN is the number of foreign subsidiaries; LEV is the proportion of total liability over total assets; LOSS is an indicator variable equals to '1' if the firm has made loss in any of the years, '0' if otherwise; AQ an indicator variable equals to '1' if the firm hires Big4 auditor and '0' if otherwise; PCON is an indicator variable equals to '1' if PCON firm and '0' if otherwise; IND is the proportion of independent non-executive directors to audit committee; DIL is the number of meetings; EXP is the number of audit committee with accounting or finance qualification; IND_PCON is an interaction between IND and PCON; DIL_PCON is an interaction between DIL and PCON; EXP_PCON is an interaction between EXP and PCON.

Model 1 show the association between external audit fees on 9 control variables derived from the extant literature (Abbott *et al.,* 2003, Goodwin and Kent, 2006; Yatim *et al.,* 2006; Abdul Wahab *et al.,* 2009). TA and NAF coefficients of 0.054 and 0.080 are positive and significant indicating that the larger the size of firms, the higher the audit fees charged. The coefficient on LEV of -0.062 is negative and significant. PCON In addition SUB (0.686) indicates that as the complexity and risk becomes higher, the audit fees also increase. AQ and PRD are also positive and significant at *p*<0.05. (0.040) is also positive and significant. However, contrary to prediction, FOREIGN is negatively associated with audit fees at (*p*<0.01).

Model 2 brings in the interaction variables, political connections (PCON) which comprise of three Models I, II and III. Hypotheses 2a, 2b and 2c predict a stronger relationship between audit committee characteristics, IND, DIL and EXP with AF for PCON firm's post-BMLR 2008. The results indicate that the interaction terms are significant. It reveals that there is a stronger association between the audit committee IND, DIL and EXP, and audit fees for PCON firms for post-BMLR 2008 implementation, thus H2a, H2b and H2c are supported. As reported by Botica *et al.* (2011) there is a positive association between audit committee and audit fees and the results are consistent with audit committee being an important monitoring mechanism. This is because under the demand side perspective, audit committee members who meet frequently are more informed and knowledgeable about relevant accounting and auditing issues (Raghunadan *et al.,* 1998; Fogarthy and Kalbers, 1993; Goodwin and Kent, 2006). Further, as supported by DeZoort (1997) and DeZoort and Salterio (2001), skilled audit committee members have a better understanding of the risks faced by the auditor. Hence, independent, diligent and having financial expertise audit committee members who sit on PCON firm's board demand for substantive external audit work and are willing to pay higher audit fees.

The findings of this study also corresponds to the Transformation Program[2] which was introduced by the government to enhance corporate governance, develop social leaders and clarify social obligations to steer the favoured firms, particularly in upgrading the effectiveness of the board (Najid and Abdul Rahman, 2011). Besides that, the Green Book guidelines may have led the PCON firms to adopt stronger governance by enhancing board effectiveness (Khazanah's Green Book, 2006). Firms that are committed to strong corporate governance demand for additional assurance from auditors and higher audit quality

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[2]Catalyzing GLC Transformation to Advance Malaysia's Development, Section II-Policy guidelines; GLCsTransformation Manual.

(Lifschutz *et al.,* 2010). Hence, the PCON firm's audit committee members are committed to strong corporate governance. They are in place to monitor the management, who otherwise may act in their own personal best interest and not in the interest of the shareholders. Further, the operational enhancement initiatives outlined in the Manual has already taken effect since it was introduced in 2005. This is part of the initiative taken by the regulatory institutions is to inculcate good governance practices in the corporate sector. It is believed that the Program may have influenced the PCON firms as they are claimed to be favoured organizations by the government.

The signs for the control variables are all in predicted directions except for FOREIGN and LOSS. Following prior research (Simunic, 1980; Francis and Simon, 1987;Craswell *et al.,* 1995) it is expected that the audit fees (AF) is positively associated with TA, NAF, SUB, and AQ. All other variables remain significant with the exception of LOSS.

4. Conclusions

This research uses an agency theory framework to examine the impact of having an independent, diligence and with accounting expertise audit committee, representing the interest of corporate owners as a counter to the potential self interest of management. Prior results on the relationship between internal governance mechanisms and audit fees have been inconclusive and provide conflicting results. This study examines the relationship between audit committee characteristic and audit fees in Malaysia. It is predicted that the BMLR 2008 mandatory regulations on the audit committee are positively associated with higher audit fees for PCON firms. The panel analysis of 945 firm year observations for the period 2005–2009 reveals that PCON firms pay higher audit fees than non- politically audit fees and stronger relationship between audit committee IND and DIL, and audit fees for PCON firms post BMLR 2008 implementation. This is because much attention and initiatives have taken place to ensure that the PCON firms perform in an effective way and assist the government to improve the economic growth.

The government intervention is to produce better governance and improve the firms' business performance. In order to protect their reputational capital, the audit committee will demand additional assurance from external auditors and require more extensive audit testing and hence higher external audit fees.As the use of agency theory on its own has been criticized (Ahrens *et al.,* 2011), we complement this theory by drawing on the political embeddedness perspective to take cognizance of the uniquely relationship-based institutional context in Malaysia. This extends the corporate governance literature to evidence the moderating effect of political connection on the relationship between internal corporate governance mechanisms and audit fees. The inclusion of political embeddedness perspective explains the political relationships between the PCON firms and the government. Thus, corporate governance does matter for politically connected firms as suggested by Chan *et al.* (2012).

In evaluating these results, several limitations should be taken into consideration, hence provide opportunities for further research. First, this study relies on the studies of Johnson and Mitton (2003), Mohamad *et al.* (2006), Abdul Wahab *et al.* (2009 and 2011) as well as Khazanah Berhad web site (www.khazanah.com.my). However, firms which are listed in the

said previous studies as PCONs but do not have complete data are excluded from this study. Second, this study is based on the BMLR 2008. With the revision of the MCCG in 2012, the BMLR was further revised in November 2012. Although the requirement on audit committee characteristics was not raised, there are now additional requirements on corporate governance such as the establishment of a nomination committee. In addition, a longitudinal study, expanding more than five years as pre-test and post-test periods would be beneficial in measuring the long term impact of governance on audit fees.

Acknowledgement

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