

Determinants of Audit Fees among Public Listed Companies in Malaysia. A Theoretical Model

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Abstract *The purpose of this study is to examine the determinants of audit fees among listed manufacturing companies in Malaysia. A theoretical framework was constructed to test the relationship between audit fee determinants and audit fees with the adoption of five independent variables which are profitability, corporate size, complexity, status of audit firm and audit client's risk. The analysis is based on a sample of public listed manufacturing companies covering a time period of five years comprising of year 2009 to year 2015. Secondary data collection method will be employed in this study to obtain data from annual reports published by Bursa Malaysia. The data collected were subsequently used to analyze the relationship between the five selected independent variables and audit fees by conducting multiple regression analysis. This study is expected to provide important insights to listed manufacturing companies in Malaysia into the determinants which are significantly related to audit fees charged by the auditors and helps auditors in pricing the audit services appropriately. Besides this, regulatory bodies can use this research to regulate the practice of audit pricing. This study also contributes an improved research model that incorporates new variable (audit client risk) which is found to be significant associated with audit fees and the sample period covered will be after the implementation of GST and IFRS.*

Key words Audit fees, profitability, organization size, Audit Client Risk, Status of Audit Firm and complexity

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1. Introduction

According to Shafie, Che Ahmad, and Ali (2007), Malaysian regulators require the audit fees to be disclosed in the company's annual report in accordance with Company Act 1965. A "Recommended Basis for Determining Audit Fees" has been issued by MIA as a guideline on the charging of audit fees but the amount of fees paid depends largely on the audit skills, knowledge and time required in performing audit works (Paino and Tahir, 2012). Besides, according to Sundgren and Svanstrom (2013), the level of audit fees is usually in line with the audit quality (Ask & Holm, 2013). However, the amount of fees charged is often in contra with the audit fees perceived by the client. Hence, it is important to know how audit fees are priced differently and whether the fees are charged reasonably within the auditing industry (Kwong, 2011). Based on the review of past studies, the audit fees charged by the auditors have increased in Malaysia. It is found that the average audit fees had been increased by 10 percent from year 1997 to year 1998 (Hariri *et al.*, 2007). For example, the average audit fees in year 2003 was RM191, 875 (Yatim *et al.*, 2006) compared with RM248, 376 in year 2007 (Malek and Che Ahmad, 2012). In the Malaysian context, it is known that Malaysian Accounting Standards Board (MASB) has brought Malaysia to full convergence with IFRS by 1 January 2012. According to Yeow and Mahzan (2013), there are more than one thousand public companies listed in Malaysia will be influenced by the fully IFRS convergence in 2012.

2. Problem statement

Audit pricing services have been an important issue that concerns many researchers to have carried out researches by examining the types of determinants that affect the audit fees (Al-Harshani, 2008). In addition, there are also controversies due to different fees charges by auditors in different industry and the questions about the impact of corporate size, complexity and client risk on audit fees (Al-Matarneh,

2012). Many recent studies have also identified the variables such as profitability, status of audit firm, and corporate size that influencing audit fees were conducted by Mohammad Hassan and Naser (2013) in Abu Dhabi Stock Exchange (ADX), El-Gammal (2012) in Lebanon, Al-Matarneh (2012) in Jordan and Al-Harshani (2008) in Kuwait. Based on review of past studies it is proven that it is an ongoing research and substantially proving types of determinants affecting the audit fees are still an issue that concerned by clients. There is a lack in studies being carried out on the audit pricing services in Malaysia, and current studies have omitted the audit client risk factors and there is also limited studies were conducted after the GST implementation in Malaysia. Hence, this has led the auditor to attend more training in order to update their knowledge. Therefore, the impact might be on the audit fees.

(Lin, 2016) predicts that IFRS experience will have a positive impact on audit fees in the initial years of IFRS adoption for two reasons. First, IFRS requires more professional judgments than the Chinese GAAP, which implies higher audit risk. The audit risk is client-specific and cannot be reduced by auditors even if they have prior IFRS-related experience.

However, there are several deficiencies in the past studies. Firstly, the settings of the paper is based on the common law and developed countries, hence, impact of audit fees after post-IFRS adoption may be different in Malaysian context (George *et al.*, 2013). Secondly, the result is believed to be less accurate as the data was obtained between 2004 and 2008 due to the stage-by-stage implementation of IFRS (Yaacob *et al.*, 2012), therefore, it is not considering the impact of audit fees after IFRS convergence (Yeow *et al.*, 2013). Thirdly, the authors merely concentrate on the audit attributes such as audit complexity rather than clients attributes like client risk and client size (Kim *et al.*, 2013). Lastly, the study investigated the impact on audit fees after IFRS adoption in the consideration with government changes in regulatory in New Zealand may not bring the same result as in Malaysia (Griffin *et al.*, 2009). Moreover, most of the past studies were conducted before the GST implementation in Malaysia and lack of evidence pertaining to this matter.

3. Audit Fees

The amounts of fees (wages) charged by the auditor for an audit process performed based on the time spent, the service required, and the number of staff involved in the audit process (El-Gammal, 2012). According to the International Standards on Auditing, audit fees are defined as the amount that compensates the financial auditor's activities and qualifications of financial statements (Chersan *et al.*, 2012). The Audit Fee Model is the main theoretical foundation in examining the factors that influence the external audit pricing (Al-Harshani, 2008). According to Simunic's study which is conducted in 1980 (as cited in Cameran, 2005), audit fee is a product which auditee demand the unit price and quantity of audit services. The analysis of audit fees volatility requires the need of Audit Fee Model to determine the audit fees level with the presence of IFRS (Griffin and Lont, 2007). The Audit Fee Model has been extensively used in different research areas such as investigating the audit fee premium with the effect of Sarbanes-Oxley Act 2002 (Ebrahim, 2010; Griffin *et al.*, 2007; Salman and Carson, 2009).

4. Profitability

Profitability is used to evaluate the performance of the company (Moradi *et al.*, 2012). Profitability acts as an indicator of management performance and efficiency in allocating available resources (El-Gammal, 2012). Mohammad Hassan and Naser (2013) investigated whether audit fees charged by nonfinancial companies would be influenced by company profitability. Based on the annual reports and governance reports from 30 Emirati nonfinancial companies on Abu Dhabi Securities Exchange (ADX) during year 2011 showed a positive insignificant association between the audit fees and the profitability. This finding is consistent with Moradi *et al.* (2012) examined the relationship between firm profitability and audit fees charged in different firms. Data were collected based on Tehran Stock Exchange from year 2003 to year 2009. Al-Harshani (2008) investigated factors influencing the amount of audit fees in Kuwait. Data were collected through survey from six audit firms in Kuwait during year 2006 also found that audit fees are positively related to the profitability of the audit client.

However, a studies conducted by El-Gammal (2012) determined the most vital factor that affected the amount of audit fees as perceived by the different groups of respondents in Lebanon. The respondent

of this questionnaires were among employees of leading banks, employees of three of the Big 4, and middle-sized CPA firms. The results showed that profitability is insignificant to the determination of audit fees. Furthermore, Ebrahim (2010) conducted research on the analysis of the effects of Sarbanes Oxley (SOX) Act on audit fee premium and auditor change in the US audit market found that audit fees are significantly and negatively related to client's profitability.

5. Corporate Size

There are studies which define corporate size as a structural property with the degree of formalization or a contextual variable in respect of the number of people, resources and the amount of activity involved in the organization (Javed and Khan, 2011). Vermeer, Raghunandan, and Forgione (2009) proposed to provide empirical evidence about how firm size is associated with audit fees based on 125 samples from large non-profit organizations in United States and found that the firm size is associated with audit fees. Sori and Mohamad (2008) attempted to determine whether larger companies are expected to pay more external audit price than smaller companies. The findings revealed that there is a positive and significant relationship between audit fees and corporate size. A recent study of Wahab and Zain (2013), Yaacob (2013) and Naser, Al-Mutairi, and Nuseibeh (2013) found that there is a positive significant relationship between firm size and audit fees.

6. Complexity

Generally, complexity is defined as a system which consists of many entities that have a high level of non-linear interactivity (Holmdahi, 2005). There are studies also reported that complexity increase with the IFRS adoption (Kim *et al.*, 2012). A recent study was conducted by De Deorge, Ferguson and Spear (2013), to examine the relationship between IFRS adoption and audit fees in Australia and the findings showed that the amount of audit fees will be increased particularly for those firms with IFRS implementation during the year of adoption. Besides a Malaysian study conducted by Yaacob and Che-Ahmad (2012) also investigated the relationship between the complexity of new and amended IFRS and the audit fees in Malaysia and the result indicated that the audit fees were significantly increased after IFRS adoption. Kim, Liu and Zheng (2012) analyzed the impact of IFRS adoption on audit fees in European Union countries on their study conducted in 2012 and the result concluded that adoption of IFRS increased the audit fees. Moreover, Redmayne and Laswad (2013) have studied on the effect of IFRS adoption on public sector audit fees and audit effort in New Zealand and the results reported that the IFRS adoption was positively affecting the audit fees and audit effort. Griffin, Lont and Sun (2009) have examined the association between the governance regulatory forms and audit and non-audit fees in New Zealand and result revealed that audit fees were significantly increased prior to IFRS adoption, the years of adoption, and after IFRS adoption.

The authors further found that the increased fees charged by audit firms with IFRS experience are independent of the degree of changes in the financial reporting complexity of their clients. In contrast, audit clients with IFRS experience paid lower incremental fees only when they underwent a high degree of changes in financial reporting complexity (Lin, 2016).

Based on the review of past studies, it is proven that IFRS adoption has increased the audit fees and these study beliefs that GST implementation would also be able to increase the audit fees.

7. Status of audit firm

Recent research has been conducted by Siddiqui, Zaman, and Khan (2013) to investigate whether Big-Four affiliates earn audit fee premiums in Bangladesh. This study examined 122 companies listed on Dhaka Stock Exchange in 2005 and the result revealed Big-Four affiliate firms are not positively related with audit fees. A Brazilian studies by Hallak and Silvar (2012) investigated the factors affecting auditing and consulting fees in Brazilian public companies and the result indicated that audit fees are positively related with the Big Four auditor. Another studies carried out in Malaysia by Li and Zhu (2011) investigated the Determinants of Audit Fees among Listed Manufacturing Companies in Malaysia and focused on listed companies in Shanghai and Shenzhen Securities Markets showed the prestige of auditing firm is found to be significantly associated with the audit fees.

El-Gammal (2012) has examined the factors that determining audit fees and found that the status of audit firm employed by the company is significant to the determinants of the audit fees paid by multinational firms and banks in Lebanon. They are willing to pay higher audit fees because they seek higher quality audit work and the credibility of their annual reports. Another study was conducted by Van Caneghem (2010) in Belgium to investigate audit pricing and the Big4 fee premium and also demonstrated that Big4 have a very strong positive association with audit fees.

8. Audit client risk

Business risk is defined as those unforeseen changes to the legal circumstances to which insurers are subject to changes in the social and economic environment, as well as changes in business profile and business cycle (Buckham *et al.*, 2010). A recent study conducted by Koh and Tong (2012) investigated the impacts of clients' involvement in controversial corporate activities with audit pricing in United States and the result concluded that the clients involved in controversial activities will be charged higher audit fees. A study of Calderon, Wang, and Klenotic (2012) examined the association between incremental effect of internal control weaknesses and audit fees in United States and the result revealed that the relationship is positively related. However, Stanley (2011) research showed that there is a significant negative relationship between audit fees and the client firms' business risk. Tahir and Paino (2013) investigated the relationship between business client risks, fraud and audit fees in Malaysia and the result showed that firms which are not involved in fraud and have low business risk are charged with high audit fees and vice versa. The Determinants of Audit Fees among Listed Manufacturing Companies in Malaysia by Hogan and Wilkins (2008) identified reaction of auditors to the firms with high levels of control risk and the results indicated that the audit fees are positively related with internal control deficiency throughout the firms.

9. Research framework

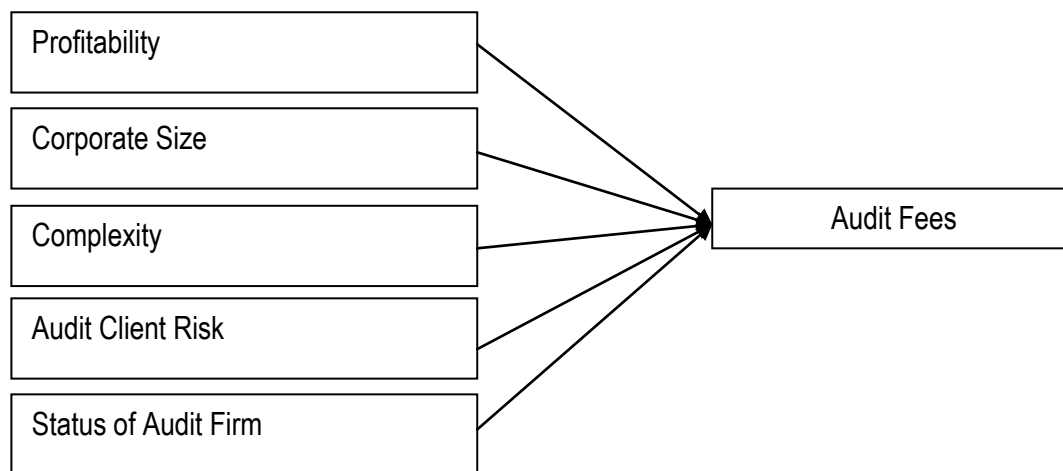


Figure 1. Research framework

10. Conclusions

The purpose of this article is to highlight the determinants of audit fees among public listed companies in Malaysia after IFRS and GST implementation. This article outlines the drivers of audit fees. On the basis of the literature review, a conceptual model has been developed. Further research should be carried out to test, validate and enhance the model. The results obtained will be presented in a later article.

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