

**ENGAGEMENT RISK, AUDITOR CHOICE AND AUDIT
FEE IN THE MALAYSIA AUDIT MARKET**

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MALAYSIA AUDIT MARKET**

By

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**Thesis Submitted to
Othman Yeop Abdullah Graduate School of Business,
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ABSTRACT

High risk of auditor litigation and audit market competitiveness motivate audit firms to place greater emphasis on the role of engagement risk in determining client-auditor relationship and audit cost (Johnstone, 2000; Johnstone & Bedard, 2004). Based on this development, this study examines the market structure and the impact of engagement risk on auditor choice and audit pricing in a low litigation risk setting. Drawing from the agency theory and its related hypotheses, the study anticipates that audit risk, auditor business risk and client business risk are significantly associated with auditor choice and audit fee. The samples of study consist of Malaysian public listed companies from 2008 to 2010. The descriptive analysis of 2,854 companies demonstrates that the Malaysian audit market can be described as a tight oligopoly. In determining the influence of risk on auditor choice and audit fee, some exclusion criteria were established. Using panel data analysis on 2,451 companies, it is found that engagement risk significantly influences auditor choice and audit fee. In particular, auditor business risk is more important than the other risks in auditor choice and it is positively associated with the choice of quality auditor whereas, audit risk elements are more dominant than the other risk factors in explaining audit fee. Auditors will charge higher audit fees for clients with higher audit risks. The engagement risk affects auditor choice and audit fee differently because of the different risk management practices by audit firms in establishing their client portfolio. Avoidance of small and risky clients among large audit firms would increase companies' difficulty to access the capital market and delay growth. This study contributes to the auditing literature by addressing the audit firm's risk management strategy in Malaysia, which is rarely investigated. The study also provides an insight into the regulator on factors that should be considered in enhancing the quality of an audit firm.

Keywords: engagement risk, auditor business risk, audit risk, auditor choice, audit fee.

ABSTRAK

Risiko litigasi juruaudit yang tinggi dan persaingan pasaran audit mendorong firma audit untuk lebih menekankan peranan risiko ikatan dalam menentukan hubungan pelanggan-juruaudit dan kos audit (Johnstone, 2000; Johnstone & Bedard, 2004). Berdasarkan perkembangan tersebut, kajian ke atas struktur pasaran dan kesan risiko ikatan terhadap pemilihan juruaudit dan harga audit dalam persekitaran litigasi berisiko rendah dilakukan. Berpandukan teori agensi dan hipotesis-hipotesis yang berkaitan dengannya, kajian ini menjangkakan bahawa risiko audit, risiko perniagaan juruaudit dan risiko perniagaan pelanggan berhubungan secara signifikan dengan pemilihan juruaudit dan yuran audit. Sampel kajian terdiri daripada syarikat awam yang tersenarai di Malaysia dari tahun 2008 hingga 2010. Analisis deskriptif ke atas 2,854 syarikat menggambarkan pasaran audit Malaysia sebagai oligopoli ketat. Bagi menentukan pengaruh risiko ke atas pemilihan juruaudit dan yuran audit, beberapa kriteria pengasingan sampel dilakukan. Kaedah analisis data panel digunakan untuk melihat kesan risiko ke atas 2,451 syarikat. Kajian ini mendapati bahawa risiko ikatan mempengaruhi secara signifikan pemilihan juruaudit dan yuran audit. Secara khususnya, risiko perniagaan juruaudit adalah lebih penting berbanding risiko-risiko lain dalam pemilihan juruaudit dan berhubungan secara terus dengan pemilihan juruaudit berkualiti tinggi. Manakala unsur risiko audit lebih menyerlah daripada faktor-faktor risiko lain dalam menerangkan yuran audit. Juruaudit akan mengenakan yuran lebih tinggi kepada pelanggan yang mempunyai risiko audit yang tinggi. Risiko ikatan mempunyai kesan yang berbeza ke atas pemilihan juruaudit dan yuran audit disebabkan oleh kepelbagaian strategi pengurusan risiko yang diamalkan oleh firma audit dalam mewujudkan portfolio pelanggan. Keengganan firma audit besar untuk mengaudit pelanggan bersaiz kecil dan berisiko boleh meningkatkan kesukaran syarikat menembusi pasaran modal serta melambatkan pertumbuhan syarikat. Kajian ini menyumbang kepada karya audit dengan mengenal pasti strategi pengurusan risiko di kalangan firma audit Malaysia yang jarang dikaji sebelum ini. Kajian ini juga memberi maklumat kepada pihak pemantau audit tentang faktor-faktor yang patut dipertimbangkan dalam meningkatkan kualiti audit.

Kata kunci: risiko ikatan, risiko perniagaan juruaudit, risiko audit, pemilihan juruaudit, yuran audit.

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LIST OF ABBREVIATIONS

AoA	Articles of Association
AICPA	American Institute of Certified Public Accountants
ACE	Access, Certainty, Efficiency
AOB	Audit Oversight Board
APM	Audit Planning Memorandum
ASEAN	Association of Southeast Asian Nations
BLUE	Best Linear Unbiased Estimators
BMCGG	Bursa Malaysia's Corporate Governance Guide
BOD	Board of Directors
CCM	Companies Commission of Malaysia
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CPA	Certified Public Accountants
FRS	Financial Reporting Standard
GAFN	Global Audit Firms Network
GM	General Manager
IAASB	International Auditing and Assurance Standards Board
IFRS	International Financial Reporting Standards
IMR	Inverse Mills Ratio
IPO	Initial Public Offerings
ISA	International Standard on Auditing

ISQC	International Standard on Quality Control
MCCG	Malaysian Code on Corporate Governance
MFRS	Malaysian Financial Reporting Standards
MIA	Malaysian Institute of Accountants
MICPA	Malaysian Institute of Certified Public Accountants
MSA	Malaysian Standards on Auditing
NAS	Non-audit Services
NED	Non-executive Directors
NYSE	New York Stock Exchange
OECD	Organisation for Economic Co-operation and Development
OLS	Ordinary Least Squares
PCAOB	Public Company Accounting Oversight Board
PIE	Public Interest Entities
PII	Professional Indemnity Insurance
PLC	Public Listed Companies
PwC	PricewaterhouseCoopers
ROA	Return on Assets
ROSC	Report on the Observance of Standards and Codes
RM	Ringgit Malaysia
UK	United Kingdom
US	United States
SC	Securities Commission
SOX 2002	Sarbanes-Oxley Act 2002

CHAPTER 1: INTRODUCTION

1.1 Background of the study

The audit service industry commenced the second millennium with an unpleasant episode, which was the collapse of Enron and Andersen¹ in the United States (US) in the year 2001. The downfall of Andersen, one of the largest audit firms,² was regarded as a major event in the development of the US audit market (Doogar, Sougiannis & Xie, 2003). This was followed by other major business failures within and outside the US, such as in the Netherlands (e.g. The Royal Ahold case) and in Italy (e.g. the Parmalat case). The failures are not confined to developed or Western countries, as there were also business failures in Asia, such as in Japan (e.g. the Kanebo case) and in India (e.g. the Satyam Computer Services case). In Malaysia, similar financial scandals include Megan Media Holdings Bhd., Transmile Group Bhd. and Welli Multi Corporation Bhd.

Seven years after Enron, the US economy was affected again, but this time by the subprime mortgage crisis.³ The crisis resulted in financial problems and a huge

¹ Andersen was the auditor for Enron. There was major asset write-down for Enron in 16 October 2001. On 15 June 2002, Andersen was convicted for shredding Enron's documents. Following this incidence, on 30 July 2002, Sarbanes-Oxley Act 2002 (SOX 2002) was introduced during the administration of President George Bush. The failure of Andersen and Enron resulted in other clients' of Andersen experiencing negative market reactions and the shareholders downgrading the audit quality of Andersen (Chaney & Philipich, 2002).

² Arthur Andersen discontinued its forename in March 2001 and starts to use "Andersen". As of 2002, there are four largest audit firms after the demise of Andersen due to firm's role as the auditor for Enron. Andersen's business in Malaysia merged with Ernst & Young and after the merger, the firm carried the name of Ernst & Young. The largest four firms, also known as Big Four firms, consist of Deloitte Touche Tohmatsu or Deloitte, Ernst & Young or EY, PricewaterhouseCoopers (PwC) and KPMG. Prior to 2002, Big Four are referred to as Big Eight, Big Six and subsequently Big Five or sometimes, as large firms. The terms are used interchangeably throughout this thesis.

³ The crisis arises mainly due to the easiness of getting housing loans without considering the risk of loan default in the future (Nissanke, 2010).

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