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

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

By

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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


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

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<td>AoA</td>
<td>Articles of Association</td>
</tr>
<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>ACE</td>
<td>Access, Certainty, Efficiency</td>
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<tr>
<td>AOB</td>
<td>Audit Oversight Board</td>
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<tr>
<td>APM</td>
<td>Audit Planning Memorandum</td>
</tr>
<tr>
<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
</tr>
<tr>
<td>BLUE</td>
<td>Best Linear Unbiased Estimators</td>
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<tr>
<td>BMCGG</td>
<td>Bursa Malaysia’s Corporate Governance Guide</td>
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<tr>
<td>BOD</td>
<td>Board of Directors</td>
</tr>
<tr>
<td>CCM</td>
<td>Companies Commission of Malaysia</td>
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<td>CEO</td>
<td>Chief Executive Officer</td>
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<tr>
<td>CFO</td>
<td>Chief Financial Officer</td>
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<tr>
<td>CPA</td>
<td>Certified Public Accountants</td>
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<tr>
<td>FRS</td>
<td>Financial Reporting Standard</td>
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<td>GAFN</td>
<td>Global Audit Firms Network</td>
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<tr>
<td>GM</td>
<td>General Manager</td>
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<td>IAASB</td>
<td>International Auditing and Assurance Standards Board</td>
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<tr>
<td>IFRS</td>
<td>International Financial Reporting Standards</td>
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<tr>
<td>IMR</td>
<td>Inverse Mills Ratio</td>
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<td>IPO</td>
<td>Initial Public Offerings</td>
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<td>ISA</td>
<td>International Standard on Auditing</td>
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<td>Acronym</td>
<td>Description</td>
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<tr>
<td>ISQC</td>
<td>International Standard on Quality Control</td>
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<td>MCCG</td>
<td>Malaysian Code on Corporate Governance</td>
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<td>MFRS</td>
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<td>NAS</td>
<td>Non-audit Services</td>
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<td>NED</td>
<td>Non-executive Directors</td>
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<td>NYSE</td>
<td>New York Stock Exchange</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>OLS</td>
<td>Ordinary Least Squares</td>
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<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
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<td>Public Interest Entities</td>
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<td>ROA</td>
<td>Return on Assets</td>
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<td>ROSC</td>
<td>Report on the Observance of Standards and Codes</td>
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<td>RM</td>
<td>Ringgit Malaysia</td>
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<td>UK</td>
<td>United Kingdom</td>
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<td>US</td>
<td>United States</td>
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<td>SC</td>
<td>Securities Commission</td>
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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 Andersen\(^1\) 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

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\(^1\) 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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