# PERCEPTIONS ON AUDIT COMMITTEE AND AUDITOR INDEPENDENCE IN MALAYSIA

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**Abstract**

This paper investigates the perceptions of decision makers in listed corporations on the importance of audit committees in ensuring external auditor independence in reporting financial information as part of the efforts to enhance corporate governance through an effective internal control system of public listed firms. Issues pertaining to activeness of audit committee, submission of compulsory audit committee reports, approval and review of audit fees by audit committee and the independence of the audit committee reflected by number of independent and non-executive directors. The relevant information on the issues of interest was solicited from auditors, loan officers and senior managers of Malaysian public listed companies using questionnaires and interviews. The questionnaire survey revealed that the majority of the respondents agreed that auditor independence could be effectively enforced through the presence of an active audit committee. This includes an audit committee report in the annual report, the audit committee being responsible for approving and reviewing audit fees, and majority of audit committee members are independent and non-executive. The information obtained from the interview survey was similar to the findings documented by the questionnaire survey. This indicates that the respondents believe that if enforced objectively, the audit committees in the Malaysian capital markets, could improve transparency and objectivity in reporting financial information to stakeholders and hence improve corporate governance.

**Keywords**: Audit Committee, External Auditors, Corporate Governance.

## PERCEPTION ON AUDIT COMMITTEE AND AUDITOR INDEPENDENCE IN MALAYSIA

### Introduction

The Malaysian government has embarked on the "Capital Market Master Plan" as an effort towards making these markets comparable, if not better, than the capital markets of the developed nations. This is in consonance with the ambition to make Malaysia a developed nation by the year 2020. The master plan, among other objectives, was to help improve the corporate governance of the corporate sector through an effective internal control system enforced through audit committees to help increase confidence of international investors and hence the economy.

The history of audit committees in Malaysia began when the central bank (Bank Negara Malaysia (BNM)) advised the financial institutions in the country in 1985 to set up audit committees. In 1991, the government encouraged the setting up of these committees in listed firms to strengthen the financial reporting and provide an early warning system. However, since 1994, section 344A of the Stock Exchange listing requirements has made it mandatory for every firm seeking a listing on the exchange to form an audit committee comprising of members that are independent of the company's management. Listed firms were given a grace period of twelve months (from 1st August 1993) to form an audit committee. This requirement was imposed to improve investors' confidence and corporate governance in the capital market. In view of supporting the audit committees effectively conduct their responsibilities, the stock exchange listing requirements were revised with additional requirements effective from 1st June 2001.

The concept of audit committees has been in existence for decades; though there is no consensus on the definition of what is an audit committee. For example, Collier (1997) suggests that it is a subcommittee of the main board (Cotter and Silvester, 2003; Porter *et al.*, 2003); it is comprised of a majority of non-executive directors (Abbott and Parker, 2001; Abbott *et al.*, 2003); and it plays a role in the review of financial reporting process, communicates with the auditors, and reviews internal controls (AISG, 1977; Walker, 2004). In the U.S., Levitt (2000) pointed out that, "…qualified, committed, independent, and tough-minded audit committees represent the most reliable guardians of the public interest".

Audit committees serve as a bridge in the communication network between internal and external auditors and the board of directors, and their activities take into account the review of nominated auditors, the overall scope of the audit, the results of the audit, internal financial controls and financial information for publication (AISG, 1977; FCCG, 1999). Indeed, the existence of audit committees is crucial to monitor the relationship of auditors and clients' management (Fearnley and Beattie, 2004). Spira (1998) found that audit committee would be effective if the committee have a good communication network with management. The literature has documented that audit committees are able to enhance discussions and decrease the level of negotiation between management and auditors, and as a result, reduce the level of confrontation between these two parties (Beattie *et al.*, 2000). When regular reviews and discussion exist between audit committees and related parties, Lam (1975) believed that there would be a reduced tendency for management to dominate and manage the accounting process. Thus, the audit committee provides a critical oversight of companies' financial reporting and auditing processes (Walker, 2004). However, Spira (2003) found that the level of communication is constrained by the management and inhibits the improvement in the quality of financial reporting.

McMullen (1996) and Dechow *et al.* (1996) provides evidence of a negative association between the existence of an audit committee and aggressive reporting behaviour, implying effectiveness of audit committees is pursuing their responsibilities.

This paper investigates the perceptions of decision makers in listed corporations on the importance of audit committees in ensuring external auditor independence in reporting financial information as part of the efforts to enhance corporate governance through an effective internal control system of public listed firms. Issues pertaining to activeness of audit committee, submission of compulsory audit committee reports, approval and review of audit fees by audit committee and the independence of the audit committee reflected by number of independent and non-executive directors.

The paper is organised into five sections. The following section offers literature review on audit committee. Section three describes the data collection and research methodology. Section four presents the research findings and discussions. The final section concludes the paper.

**Literature Review**

There is substantial evidence documented on various aspects of audit committees in the developed capital markets. Due to time and scope constraint, only the relevant literature pertinent to the issues addressed are briefly discussed.

A perceived advantage of having an audit committee is that it help enhance auditor independence (Beattie *et al.*, 1999; Fearnley and Beattie, 2004)[1]. Knapp (1987) discovered that an audit committee is more likely to support the auditor instead of management in audit disputes and the level of support is consistent across members of the audit committee, regardless of whether the member is in a full time or part time position, such as corporate managers, academicians and retired partners of CPA firms. Pearson (1980) and Dockweiler *et al.* (1986) found similar results, in that auditors' reliance on management is reduced due to the direct communication with the audit committee. Beattie *et al.* (1999) reported that audit partners, finance directors and financial journalists believed that audit committee that is independent of management could strongly encourage auditor independence.

Audit committees could play a role in selecting auditors, determining their remuneration and dismissal/retention of auditors. Braiotta (1999) and Goldman and

[1] It is well recognised that auditor independence plays an important role in ensuring good corporate governance (Spira, 1999; 2003), This is because the auditor has experience with the client's business and industry, and thus has knowledge and skills that could assist governance agents in the establishment of sound practices, and can provide valuable information and counsel to them (Roussey, 2000; Spira, 1998).

Barlev (1974) maintained that audit committees could monitor the financial reporting process and provide recommendations in the selection of auditors, negotiation of fees and termination of external auditors, which would ultimately diminish management's power over the auditor. Thus, the audit committee is anticipated to ensure that the firm has sufficient internal controls, proper accounting policies, and independent external auditors that will prevent the incidence of fraud and promote high quality and timely financial statements.

Moreover, independent directors of audit committees would be expected to increase the quality of monitoring because they are not associated with the company either as officers or employees; thus, they would act as the shareholders' watchdog. In the UK, Collier (1992) discovered that the practices of audit committees were more common in financial institutions than industrial corporations and believed that this phenomenon had arisen due to the institutional and regulatory framework requirement to form audit committees.

Furthermore, the tendency to switch from less credible to more credible auditors occurs more often in companies with audit committees than in companies without audit committees (Kunitake, 1983; Eicheneher and Shields, 1985). Kunitake (1981) believed that independent directors of audit committees might have exposure to larger and better-known CPA firms rather than to local or regional firms, through their involvement as officers or directors of other public corporations. Also, Kunitake (1983) found that there was less frequent auditor switching in companies that had audit committees than companies that did not have audit committees. These results indicate that the audit committee acts as a catalyst to enhance good financial reporting and support the role of external auditors.

The formation of an audit committee would improve financial statements' credibility and reliability through providing assurance on the objectivity of financial statements to shareholders (AICPA, 1967; Auerbach, 1973; FCCG, 1999). However, if audit committees are form just to comply with the requirement of the exchange and ignore the spirit of the requirement, there would not be any effectiveness of enchancing the corporate governance in the capital market. In Malaysia, Shamsher *et al*. (2001) found that a large majority of listed companies comply with all regulations imposed on them in the letter but not in the spirit, for example, the requirement to disclose audit committee reports is complied without concern for the quality of these reports.

Although audit committees act as a tool to protect the interests of minority shareholders and investors, activities undertaken by audit committees during the financial year are not accessible to the public because these documents are usually classified as 'private and confidential' (Shamsher *et al*., 2001). In the recently amended stock exchange Listing Requirements, audit committees of Malaysian public listed firms are required to prepare audit committee reports that provide additional information like committee composition, terms of reference, meeting frequency and attendance, activities summary and the existence of an internal audit function and a summary of the activities undertaken (BMB, 2001).

The requirement of submission of audit committee reports with the financial statements will provide investors with a better understanding of the committee's oversight role in the financial reporting process (Shamsher *et al.*, 2001). However, Shamsher *et al.* (2001) discovered that a large majority of Malaysian audit committees only report their terms of reference (i.e. only what they are expected to do) in the audit committee report (ACR) and nothing is reported on what they have actually done. Hasnah *et al.* (2005) supports the notion that that Malaysian listed companies produced uniform type of audit committee reports without revealing the actual activities performed during the stipulated period. On the other hand, most companies do not provide ACR for the reason that they believe such disclosures will become 'lega1istic boilerplates' that lack useful information (Cook, 1993) and that create additional liability to the independent director (Kintzele *et al.*, 1993; PriceWaterhouse, 1993; Rezaee and Farmer, 1994)[2]. Turpin and DeZoort (1998) found that only 15% (5 cases) of their sample provided ACR other than the 'lega1istic boilerplates' and noted that three of these five cases provided further comments on financial information.

An independent audit committee is an effective committee. Therefore audit committees must be independent of the management of the firm or least perceived or seen to be independent for it to have any credibility on pursuing its responsibilities. Lam (1976) found that the perception of independence of the committee enhance auditor independence and make the management and auditors more objective in financial reporting. Thus, independent directors have a greater incentive to avoid activities that would damage their reputation than non-independent directors (Abbott and Parker, 2000; Abbott *et al.* 2003; Hussain and Mallin, 2003). Beasley (1996) documented that firms committing financial statement fraud had a significantly lower percentage of independent outside directors than similar firms not committing such acts. Klein (2002) showed a negative association between board independence and earnings management. Vicknair *et al.* (1993) argued that non-independent directors on the boards of audit committees could have a negative effect on the financial reporting process. Also, Abbott and Parker (2000) discovered that active and independent audit committees tend to hire industry specialist auditors. Raghunandan *et al.* (2001) revealed that audit committees that consist solely of independent directors that have at least one member with accounting or finance credentials tend to have longer meetings and meet privately with the chief internal auditor, assess the internal auditing program and results, and review management's interaction with internal auditing. DeZoort and Salterio (2001) discovered that independent audit committee members possess higher audit knowledge and tend to defend auditors in accounting conflicts. However, Spira and Bender (2004) rejected the above arguments and noted that audit committee effectiveness can be profiled based on their attributes that reflects their independence from management (Spira, 1999)

[2] The term 'legalistic boilerplate' has been used in Turpin and DeZoort (1998) to describe the phenomenon where most of the audit committees in their sample only provide their reports in a form that follows the recommended report that provides a description of activities and functions.

An active audit committee would enhance their role to pursue the terms of reference and objectives (FCCG, 1999; Treadway Commission, 1987; Public Oversight Board, 1993). The frequency of audit committee meetings would indicate their activeness, and Menon and Williams (1994) discovered a positive relationship between meeting frequency and the presence of outside directors. The BRC (1999) and the Treadway Commission (1987) suggested that audit committees should meet at least four times a year. Bedard *et al*. (2004) discovered audit committees that meet more than twice a year, have member(s) with financial knowledge (i.e. financial expertise) and consist solely of independent directors are associated with less income-increasing earnings management (or are more independent). They also found a positive association between the financial expertise of audit committee members and reduced income-decreasing earnings management. The above empirical evidence provides support for the argument that active audit committees help maintain the integrity of the financial reporting process (DeFond and Jiambalvo, 1991; Dechow *et al*., 1996)

Despite the support shown for the independence of audit committees, Gul (1989) reported that the bankers he surveyed did not perceive that audit committees enhanced auditor independence. Gul (1989) concluded that the result might indicate that, "there was little awareness of the role and importance of audit committees amongst New Zealand bankers because relatively few companies in New Zealand have set up audit committees" (p.48).

**Methodology**

The information on the issues of concern was obtained, first, through a postal questionnaire to three different respondent groups, namely auditors, loan officers and senior managers of public listed companies. The second stage entailed a series of interviews with senior managers of audit firms, banks and publicly listed companies aimed at obtaining more precise understanding of the issues concerning the importance of audit committee and auditor independence. The questionnaire was designed and pilot-tested on a sample of targeted respondents to maximise the chances of getting the required information to address the issues. The total of 800 questionnaires were distributed with a response rate of (Table 1) 31%, 44% and 36% from auditors, loan officers and senior managers of public listed companies respectively.

The targeted respondents were identified based on the literature that classified them as the key players in the audit market (FCCG, 1999). Auditors were selected because they are the main subjects of the issue of interest that provide certification and/or information credibility assessment to the stakeholders (Humphrey, 1997). Furthermore, Flint (1988) pointed that the person to whom the audit reports is addressed and the person that are subjected to audit have a direct interest in the audit outcome. Gul (1991) argued that bank officers are relatively sophisticated financial statement users who could be expected to understand the importance of auditor independence. Finally, the manager is the agent of the principal, who conducts business on behalf of the principal and, hence, requires a monitoring mechanism (i.e. an auditor) to report on their performance (see Jensen and Meckling, 1976), and on this basis, senior managers of public listed companies' perceptions of auditor independence are valuable to this study.

**TABLE 1 HERE**

An analysis of the designation of the respondents tabulated in Table 2 shows that 46% of the auditors who responded are in the position of line managers, while 47% and 43% of the loan officer and corporate management groups respectively come from senior managers, the remainder being the first line of management and the chief executives of the respective organisations. This result indicates that the majority of the respondents are, for the most part, responsible for the auditing, accounting and finance function. The seniority of the respondents provides strong support for validity of the responses.

**TABLE 2 HERE**

The respondents were also asked to provide information on their length of experience in their particular function. Table 2 shows that more than 80% of the respondents had more than 5 years' experience in their respective functions. The length of service indicates the respondents are well versed with their job functions and subsequently are informed about the changes in the accounting and auditing profession.

The possibility of occurrence of non-response bias arises when some of the respondents failed to return the questionnaire and the data on returned questionnaires may consequently turn out to be invalid[3]. To ensure the reliability and validity of the data, the presence of non-response bias was tested using the technique recommended by Oppenheim (1966) and Wallace and Mellor (1988). The information gathered had no non-response bias.

The information gathered from the survey could have self-selection bias (Eysenbach and Wyatt, 2002; Oppenheim, 1992; Whitehead, 1991)[4]. The bias might arise from the fact that "people are more likely to respond to a questionnaire if they see items which interest them" (Eysenbach and Wyatt, 2002) and "they may try to 'respond' extra-well" (Oppenheim, 1992) to the questions. This study employed control and experimental respondent's technique developed by Oppenheim, 1992 and found that the effect of self-selection response bias was minimal. This information gathered on the issues of interest by both the questionnaires and interviews were not contradictory, consistent with the notion that the there was no self-selection response bias.

A detailed analysis of the period of employment of the respondents participating in the interview is provided in Table 3.

**TABLE 3 HERE**

[3] It is well recognised in the literature that responses to mail questionnaires are generally poor, and it is a common phenomenon to see return percentages as low as between 30 to 50% (Wallace and Mellor, 1988, p. 132).

[4] Oppenheim (1992, p.30) termed this phenomenon as 'volunteer bias'.

The vast majority of the interviewees had more than 5 years of experience. Only 8%, 6% and 29% of the auditors, loan officers and regulators respectively had less than 5 years of experience. Hence, its perceived that the information provided by the respondents is reliable enough to be generalised to the whole population.

**Results and Discussion**

The establishment of an effectively functioning audit committee can enhance good corporate reporting and improve communication between auditors and management (Spira, 1999; Klein, 2002), and safeguard auditor independence. The respondents were asked on the issues of interest on audit committees and their views are tabulated in Table 4 and discussed below.

**TABLE 4 HERE**

*Active Audit Committee*

An active audit committee would indicate the level of effort that has been made to ensure good financial reporting. Table 4 shows that the majority of the auditors (73%) and senior managers of public listed companies (84%) agreed with the statement that an active audit committee would safeguard auditor independence; however, lower level of agreement was shown by the loan officers (49%). This reflects the unwillingness of the loan officers to acknowledge the benefits that an active audit committee might bring. Similar results were observed from the interviews (54% of the auditors; 53% of the loan officers; 59% of the senior managers of public listed companies; 57% of the senior managers of regulatory bodies). However, majority of the respondents indicate that an audit committee can function effectively if is enthusiastic and regularly meets to discuss issues concerning corporate reporting and any matters arising from business operations. This is consistent with findings in the developed market (Bedard *et al*., 2004; DeFond and Jiambalvo, 1991; Dechow *et al*., 1996). When sufficient time and effort is spent by the audit committee to review companies' transactions, this would serve as a safeguard for an objective financial reporting and auditor independence.

The interviews disclosed the view that audit committees' scope as overseers should be expanded, given the current rapidly changing economy. It was suggested that the committees should spend more time performing their duties, to meet public expectations and keep up with fast changing and complex business environment. The interviewees considered that the presence of an active audit committee as an "unspoken force in negotiation" with management. For example, a manager of a Big Four firm pointed out:

> *I believe that an active audit committee would safeguard auditor independence, as the committee will have more opportunity to debate and discuss all issues relating to financial reporting and auditor duties. When they are active, they will have ample time to gain a thorough understanding of any important issue. I would think four meetings a year would sufficient, rather meeting on a monthly basis. The maximum number of meetings required, I would say, would be six times a year.*

A financial accountant of a second board company noted that:

*Active audit committees show their seriousness in conducting their duties. If we look at audit committees in the banking industry, they meet almost once in a month and if you go through the minutes of the meetings, they are very detailed; they are doing their job.*

The majority of the senior managers of regulatory bodies interviewed indicated that the primary role of the audit committee is to monitor financial reporting practices and internal controls on behalf of the shareholders, who have a lack of information on companies' business operations. It is expected that a direct relationship exists between the frequency of meetings and the level of monitoring activities. Thus, the interviewees indicate that regular meetings will enhance audit committees' effectiveness, and reduce the occurrence of financial reporting problems. As a manager of a regulatory authority pointed out:

*…. the number of meetings is a presumption that if you have more meetings there is a focus on issues, but again it goes back to the spirit and the letter. If you are doing it just for the sake of meeting the requirements, then it's not really going to make much of the difference.*

The interviews disclosed that audit committee members should be briefed on the nature and the business conduct of the company during the first meeting. Audit committee members are expected to do some field investigation on the information given to them by visiting the business site, warehouse or factory before they attend the second meeting; thus, their subsequent discussions will be more effective due to their additional knowledge. The interviewees further suggested that in the second meeting, the members should carry out compliance tests, liase with internal and external auditors on relevant matters, and set up appropriate procedures to conduct their work. Therefore, most of the interviewees indicated that audit committee should be more active in learning, discussing and debating any material issues, and work closely with external auditors to ensure that reliable and credible information is given to stakeholders. As a vice president of a big conglomerate pointed out:

*It depends on the level of activity, but in our case we actually meet nearly every month, depending on the volume, because if there are a lot of reports, then they have to meet more often and discussion can be quite lengthy in some cases; they need to impress on the general employees that the committees is functioning and very serious in addressing control issues, for example, misappropriation and abuses. However, if there are a lot of meetings but the committee does not address the real issues, it is useless.*

A manager of a medium sized audit firm agreed with this argument and further elaborated on this issue by saying:

*Once you have been appointed as an audit committee member, you must know the nature of the business of the company, the code of conduct of the business. If you have been there for a year but you don't know the number of warehouses owned by the company, then going to the monthly meetings is useless. Ideally, the audit committee should know the business as if they run the business; therefore they can see the loopholes.*

The interviews also pointed that the frequency of meetings should depend very much on the issues and challenges faced by a particular company, and the emphasis should be on the quality of the meetings rather than their frequency. A vice president of a top bank remarked:

> *Different industries have different issues and I believe that the regulatory body should come out with a meeting guide that outlines possible issues that need further discussion and clarification, and these issues should be a common issue across the board.*

Among the issues that need attention are internal control, risk area and issues highlighted in internal audit reports. It is disclosed that an effective meeting should have a clear agenda for the meeting that outlines the issue to be discussed, and subsequently the committee should provide minutes of the meeting that delineate the issues that have been discussed, the decisions taken, resolutions made and the monitoring empowered.

*Compulsory Audit Committee Reports*

As mentioned earlier, the stakeholders are unaware of the information on audit committee activities because most of the minutes of the meetings are usually classified as 'private and confidential' (Shamsher *et al*., 2001). A clear majority of the auditors (86%) and senior managers of public listed companies (76%) agreed with the statement that auditor independence would be safeguarded if audit committee reports were to be made compulsory in the annual report (Table 4). However, the level of agreement shown by the loan officers (58%) was much lower than other group of respondents, *prime-facie* evidence that the transactions are tinted with material inconsistent with the best practice postulated by the good governance principles. However, the majority of respondents believed that the public would gain from the information in audit committee reports.

Regarding the issue of audit committee reports, the majority of the interviewees (74% of the auditors; 72% of the loan officers; 88% of the senior managers of public listed companies; 86% of the senior managers of regulatory bodies) disclosed that audit committees reports should be a part of the company's financial statement, which is consistent with the findings documented in the questionnaire survey. Although the stock exchange requires public listed companies to include audit committee reports in the annual report, the majority of the interviewees are concern on the contents of the report, since most of the reports only outline their terms of reference and expected duties to be undertaken to comply with the Code of Corporate Governance, rather than what actions have been taken to improve or sustain the expected best practices by firms. Most of the interviewees indicate that audit committee reports should cover issues of risks, exceptional items and threats arising from technology changes.

*Approval and Review of Audit Fees by Audit Committees*

Capital market participants are increasingly concerned about the potential threats or pressure received by auditors during their negotiation of audit fees with the management of client companies. The industry is competitive and management of firms might use the 'audit fees' as a leverage to ensure external auditors comply by their requests and therefore compromise the external auditor's independence. The problem might be reduced if audit committees were to undertake the role of approving audit fees. Table 4 shows that 65%, 66% and 50% of the auditors, loan officers and senior managers of public listed companies respectively agreed that auditor independence would be safeguarded if audit committees were to assume the role of approving audit fees. Similar results were observed from the interview survey. The audit committee could independently monitor the process reviewing audit fees instead of leaving this issue to the board of directors, which is consistent with the findings of Abbott and Parker (2000), Braiotta (1994) and Mautz and Newman (1970). Perhaps, if the process were properly drawn up, auditors would be able to stand up and freely express their views without any fear of fee cutting or threat of termination of services.

More than half of the interviewees (i.e. 54% of the auditors; 72% of the loan officers; 53% of the senior managers of public listed companies; 71% of the senior managers of regulatory bodies) agreed that auditor independence would be strengthened if auditors were given the responsibility to review and approve audit fees. A partner of a medium sized audit firm noted:

> *Audit committees could independently review and approve audit fees without the presence of the management. They may have a better understanding of the scope of the work, coverage, and resources required by auditors, and consequently are in a better position to review and approve a reasonable price for their services. Given the independent status of audit committee members, I suppose they could carry out this duty with peace of mind, without any influence from the company's management.*

It must be noted that the interviewees did point out that the board could influence audit committees' actions due to their position in engaging audit firms and the fact that the fees received by audit committees are approved by the board of directors. A potential conflict could emerge if the audit committee's view was not consistent with that of the board of directors. It is unlikely to happen as it was disclosed that the majority of audit committee members come from the board of directors, and if audit committees appoint auditors, approve and review audit fees, the decision effectively comes from the board of directors.

*Audit Committee Members*

It has been postulated that an audit committee can effectively function if its members comprised of independent and non-executive directors (Abbott *et al.*, 2001; Klein, 2002). The majority of the auditors (98%), loan officers (94%) and senior managers of public listed companies (88%) agreed with this statement. Panel A of Table 4 shows that the majority of respondents perceive that independent directors would be expected to impartial and support the role of the auditor. Similar results were documented from the interview survey. Directors who lack this 'independence' criterion may unable to pursue their role as internal enforcers of good financial reporting (Anwar, 2003). It may be the case that non-executive directors do not report to the CEO and are not involved in the day-to-day running of the business, so they are able to bring fresh perspectives and contribute more objectively in terms of supporting as well as constructively challenging and monitoring the management team to comply with best practices.

In fact, listed companies are required to appoint the majority of their audit committee members from independent non-executive directors who have no interest in the companies. The interviews disclosed that independent non-executive directors would enhance the oversight role of the committee through independent scrutiny of the company's financial statements and support the role of auditors. The interviews revealed that the right mix of audit committee members is essential and preferably members should come from all walks of life and have hands-on knowledge of the company's business. This view is well summarised by a manager of a Big Four firm;

> *If the member is someone hands-on with finance, the FRS, the Exchange Listing Requirements, then I believed they could read the accounts and ask good questions. But, if it just someone who is just retired or an ex-army general or a public servant, or someone who doesn't understand accounting, it's not going to be effective.*

Furthermore, it was pointed out that audit committee should have a strong support from the chief audit executive (i.e. chief internal audit). This is essential given the role of the internal auditor to provide information to audit committee. A chief internal auditor of a big conglomerate commented:

> *... they should be comprised of people who are independent non-executives. The issue is who are these people? If you have heavyweights who sit on your audit committee then you have an effective audit committee. If you have bunch of pussycats that sit on the board ... then you are not going to get results from the audit committee ...that is your own funeral. This is where the minority shareholders should play a role; their job is basically to voice their opinions at annual general meetings or EGM on the choice of directors; they can decide re-election and termination of the directors, the power is in their hands.*

The interviews also disclosed that audit committees should have some form of protection to safeguard their oversight role and prevent the board of directors from influencing their decisions. Indeed, the current requirements do not outline proper safeguards for audit committees; for example, the termination of audit committee services is in the board of directors' jurisdiction. The interviewees indicated that on certain occasion, the board of directors would use this power of termination to put pressure on the audit committee to achieve their self-interests. A strong and impartial audit committee will support the auditor in situations of conflict, disagreement over accounting principles and in issuing a negative report. As a general manager of a corporate loan division of a top bank pointed out:

> *What the authority should do is that they should be the selecting body; organisation can submit the various names, and an independent selection body should pick from these people. Once they have selected, if the organisation wants to terminate their services, they have to give various reasons to the regulatory authority. Then there will be total independence and I think that the independent body should also be responsible for the determination of salary. Whatever the perks and benefits should be totally decided by this independent body, so there are no compromises.*

This suggestion is also well-supported by a council member of a regulatory authority, who pointed out:

> *I think the mandate should come from the regulatory body or any organisation that has been authorised by the regulatory body to submit, for example MIA or MICG. So, let us say they enforce this organisation to appoint their audit committee members.*

A small minority of the interviewees, however, indicate that audit committees were unable to effectively support auditors, due to the composition of the committees, which represents executive directors. A chief of internal auditor of an insurance company pointed out:

> *Our regulations still allow executive directors to be appointed as audit committee members. The impact is great because if the executive director is the type who likes to pussyfoot around, he will influence the non-executive independent directors because this group of people do not handle day-to-day business.*

Essentially, the views of the interviewees indicate their confidence in independent and non-executive members to effectively perform the role of monitoring financial reporting, internal control and business operations. However, their concern is with the background of the executive directors who sit on the committees, who may use their position to influence the operation of audit committees.

*Conclusion, Limitations and Future Research*

The questionnaire and the interview survey revealed that the majority of the respondents agreed that auditor independence would be safeguarded by the presence of an active and independent audit committee. There were suggestion to mandate the an audit committee report in the annual report, the audit committee be responsible for approving and reviewing audit fees, and the majority of audit committee members are independent and non-executive directors. This indicates that the respondents have faith in the audit committees in the Malaysian capital market to enhance communication between auditors and management in the best interest of stakeholders.

An active audit committee is important because it will indicate the amount of effort contributed by the committee to address the appropriate issues. Audit committee reports should show activities undertaken during the financial year and also report the efforts made to ensure adequate internal control. Both surveys indicated that the rapid changes in the economy require audit committees to spend "much more time" to effectively perform their duties. It was mentioned that the frequency of meetings has a relationship with the level of monitoring activities. Majority of the auditors, loan officers and senior managers of public listed companies agreed that auditor independence would be safeguarded if audit committees were given the responsibility to approve and review audit fees, because under the current system, the shareholders give the mandate to the board of directors to appoint, approve and review audit fees.

Majority of the auditors, loan officers and senior managers of public listed companies agreed that auditor independence would be safeguarded if audit committees were made up of a majority of independent and non-executive directors. Ideally, the committee should consist of highly qualified and committed people. A strong and impartial audit committee would support the auditor in situations of conflict or disagreement over accounting principles and enhance their ability to resist management pressure. This will contribute to auditor independence and neutralise any conflict between the management and the auditor.

The findings documented in this study are not without limitations. Only the views of auditors, loan officers and senior managers of public listed companies were sought.

These are important respondents in the context of the issues addressed, but it would be complete if views of other such as the Minority Shareholders Watchdog Group, which act as representatives for minority shareholders, institutional investors, regulatory bodies, academicians, foreign investors, audit committee members, politicians and the public in general could be sought. Furthermore, there should be a continuous effort to research on the subject of interest as perceptions of auditor independence may shift over time (Gwilliam, 1987). The Malaysian auditing market is still in the developmental stage and is in the process of reforming and strengthening its control mechanisms. Following the recent well-publicised audit failures among large and established companies in developed capital markets, regulators worldwide, including those in Malaysia, are searching for better solutions enforce best practices to keep at par with the rapid changes in environment and technology.

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## Appendix 1

| Table 1: Analysis of Responses by Respondent's Category | | | | | | |
|---|---|---|---|---|---|---|
| Category | Total Questionnaires Issued | Usable Responses Received Pre-reminder | Usable Responses Received Post-reminder 1 | Usable Responses Received Post-reminder 2 | Total Usable Response | Total Usable Response Rate |
| | Frequency | Frequency | Frequency | Frequency | Frequency | % |
| Audit Firms | 300 | 25 | 30 | 38 | 93 | 31 |
| Financial Institutions | 200 | 32 | 28 | 27 | 87 | 44 |
| Public Listed Companies | 300 | 42 | 16 | 49 | 107 | 36 |
| **Total** | **800** | **99** | **74** | **114** | **287** | **36** |

| Table 2: Profile of Postal Survey Respondents Analysed by Category of Employment | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Auditors** | | | **Loan Officers** | | | **Senior Managers** | | |
| **Status** | **Number** | **%** | **Status** | **Number** | **%** | **Status** | **Number** | **%** |
| Audit Senior | 38 | 41 | Officer | 34 | 39 | Financial Accountant | 36 | 34 |
| Line Manager | 43 | 46 | Senior Manager | 41 | 47 | Senior Manager | 46 | 43 |
| Senior Manager | 12 | 13 | Chief Executive | 12 | 14 | Chief Executive | 25 | 23 |
| **Total** | **93** | **100** | | **87** | **100** | | **107** | **100** |

| Table 3: Analysis Showing the Period of Employment of Respondents Participating in the Interview Survey | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | ***Auditors*** | | ***Loan Officers*** | | **Senior Manager of Public Listed Companies** | | **Senior Manager of Regulatory Bodies** | |
| **Level of Experience** | **Number** | **%** | **Number** | **%** | **Number** | **%** | **Number** | **%** |
| Under 5 years | 1 | 8 | 1 | 6 | 0 | 0 | 2 | 29 |
| Between 6 and 10 years | 3 | 23 | 3 | 18 | 3 | 18 | 0 | 0 |
| Between 11 and 15 years | 5 | 38 | 5 | 29 | 6 | 35 | 4 | 57 |
| Between 16 and 25 years | 2 | 16 | 7 | 41 | 5 | 29 | 0 | 0 |
| More than 25 years | 2 | 15 | 1 | 6 | 3 | 18 | 1 | 14 |
| Total | **13** | **100** | **17** | **100** | **17** | **100** | **7** | **100** |

**Table 4: Analysis Showing Perceptions of Issues regarding Audit Committees**

Panel A: Analysis by Auditors, Loan Officers and Senior Managers

| | Auditors (N=93) | | | | Loan Officers (N=87) | | | | Senior Managers (N=107) | | | | Significance |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **The following audit committee issues may safeguard auditor independence:** | **Disagree %** | **No View %** | **Agree %** | **Mean** | **Disagree %** | **No View %** | **Agree %** | **Mean** | **Disagree %** | **No View %** | **Agree %** | **Mean** | |
| Active audit committee | - | 27 | 73 | 2.73 | 21 | 30 | 49 | 2.29 | 4 | 12 | 84 | 2.80 | *** |
| Compulsory audit committee reports | - | 14 | 86 | 2.86 | 3 | 39 | 58 | 2.54 | 4 | 20 | 76 | 2.73 | *** |
| Audit committee approves audit fees | - | 35 | 65 | 2.65 | - | 34 | 66 | 2.66 | 5 | 45 | 50 | 2.46 | |
| Audit committee reviews audit fees | - | 29 | 71 | 2.71 | - | 31 | 69 | 2.69 | 6 | 52 | 42 | 2.36 | *** |
| Majority independent and non-executive directors_ | - | 2 | 98 | 2.98 | - | 6 | 94 | 2.94 | - | 12 | 88 | 2.88 | |

Note: ***, ** indicates that the distribution of responses is significantly different at the 1% and 5% level respectively (using the Kruskal Wallis test).

The responses were reported on a 5-point scale ranging from 1 (strongly disagree), through 2 (disagree), 3 (no view), 4 (agree) to 5 (strongly agree). For presentational purposes these 5 points have been collapsed into disagree (scored 1), no view (scored 2) and agree (scored 3) and the reported means are calculated on this collapsed scale. However, the significance tests are based on the full 5-point distribution of responses.