CORPORATE GOVERNANCE, EXTERNAL AUDIT AND THE AUDIT PROCESS

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Abstract

This paper reports on interviews with audit partners of listed companies on their perspectives of impact of corporate governance on the audit process. Based on responses received the study finds that audit risk framework is dynamic enough to incorporate expected changes in control environment brought about by greater consciousness on the part of directors on the need for good internal control. However there is still skepticism that good governance practice has filtered through clients’ control environment as auditors believe dominant CEO’s may still moderate the effectiveness of audit committees.

Keywords: control risk, audit risk model, corporate governance, audit process, PN9

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Introduction

This paper reports on a study of what auditors perceive of the audit process carried out under an internal control environment, which conforms to best practice found in the Code of Corporate Governance. In 2001 Bursa Malaysia enforced The Code of Corporate Governance (Code) on listed companies by way of Practice Note 9 (PN 9). Corporate governance characteristics of firms and the corporate governance environment may influence the role of the statutory auditors and the audit evidence accumulation process (Piot, 2005). Auditors are an important oversight mechanism over the truth and fairness of information presented in a corporation’s financial statements. In Malaysia, the law recognizes the importance of the external audit function as all companies incorporated under the Companies Act 1965 are required to have the annual accounts audited before submission to shareholders for approval at the company’s annual general meeting. Existing research suggests that governance attributes impact on various components of the financial reporting process (Beasley et al., 2000, O’Sullivan, 2000, Craswell, 2001, Abbott et al., 2003). One of these components is the internal control environment which, if effective, would be able to detect and prevent financial statements from being misstated. Auditing standards require that auditors examine internal control and assess whether the internal controls are reliable or not before deciding on the extent, nature and timing of audit procedures. Using the audit risk model, auditors are required to assess the internal control of clients before determining how much more audit evidence needs to be gathered and how.

La Porta et al. (1998) pointed out that most studies on corporate governance focus on countries like Japan, US or UK, whilst emerging markets, like Malaysia, have been described as having corporate governance framework and institutional settings which are not similar to those found in more developed markets like the US and UK (Fan and Wong, 2005). Hence international research findings on external audit and corporate governance in an American or British setting may not be generalisable to a Malaysian corporate governance setting. Puan (2006) examines governance structures and its impact on audit by way of audit fees of Malaysian listed companies. However, the study did not ask auditors what they see as the impact of governance on audit process itself. It is therefore the objective of this study to examine how auditors perceive the impact of governance on the audit process, whether governance matters or not and if so at which stage of the audit. Best practice as per the Code is expected to improve the internal control environment of listed companies and internal control environment determines quality of internal controls as a whole. If control environment changes then, the scope of the audit work could change (leading to a more efficient audit) and the risk of misstatement could be better detected and prevented making the internal control more reliable and therefore the audit process more effective. Hence not only will such an environment reduce the risk of
poor quality financial statements but also enhances the monitoring role of external audit.

The paper is organized as follows: the next section will discuss the literature review followed by the research method. Then the results are discussed and the paper concludes.

**Literature review**

The Code is at the heart of the Malaysian corporate governance framework (Zarinah and Kar, 2003). There were legal provisions and regulatory requirements already in place before the Code was launched (Koh, 2002). These include the Companies Act 1965, the Financial Reporting Act 1983, the Securities Act 1965, The Securities Industry Act 1983, the Bursa Malaysia’s (BM) Listing Rules. The provisions in these laws and regulations deal with the duties and obligations of directors, company officers and controlling shareholders to address the issues of good governance and reduce conflict of interests at the expense of stakeholders of the company. However the Code is at the most micro level because it identifies the oversight activities to be undertaken by directors and the control environment that should emerge in a corporation if these activities are in compliance with the spirit of the Code. The Code is not legally binding but the intent is that directors explain in their annual reports how the principles of good governance have been complied with or else “explain” why not. The oversight mechanisms take the form of board sub-committees of audit committee, remuneration committee and nomination committee. The external auditors represent the external monitoring mechanism and are recognized in the Code as the focus of the activities of one of the sub-committees, the audit committee. The best practice guide in the Code prescribes, *inter alia*, that the audit committee is responsible for the appointment, dismissal and resignation of auditors, the audit fee to be paid, discussion of the nature of the audit work to be performed and the resultant findings of the auditors, notably problems and reservations arising from the interim and final audits. By bringing the audit completely within the jurisdiction of the audit committee, the best practice guide on accountability and audit recognizes the importance of the relationship between audit committees and the external audit. Collier and Gregory (1996) have shown that higher audit fees are incurred for corporations with audit committees because more meetings are required between audit committees and external auditors and audit committees may require more audit work to be performed to justify their own monitoring role. However, the study was carried out in the United Kingdom when audit committees were not compulsory, in contrast to Malaysia, where audit committees have been mandatory since 1994. In addition to audit committees, the Code expects greater independence of the board in terms of the composition of non-executives to executive directors as well as the separation of the role of the Chief Executive Director from the Chairman. These changes produce board characteristics of company governance that makes the environment in which financial statements are produced as better able to detect and control misstatements from being included in financial statements. The Code identifies three related parties in governance: directors, shareholders and auditors. It exhorts the external auditors to independently report to shareholders in accordance with statutory and professional requirements and independently assure the board of directors on the discharge of their responsibilities regarding financial reporting and internal control. By discharging its duty, the auditors help ensure that stakeholders receive good quality financial reports (free from material misstatements) as financial reports are used by investors and other stakeholders for making decisions (Anderson et al., 2004; Bushman and Smith, 2001). The main link between the board and the external auditors is the financial reporting process and the resultant financial reports, which then become the subject of audit. Since the Code expects better quality board oversight over financial reporting, board characteristics of greater independence, greater expertise and greater diligence may affect the amount of work performed by the external auditors as compared to the time period before the Code was enforced. Past studies have shown that director independence, diligence and expertise are key ingredients necessary for boards to effectively discharge their monitoring function effectively (Conger, Finegold and Lawler, 1998). Moreover audit committees can also help reduce the likelihood of misstatements arising from fraud or error (Beasley, 1996; Dechow et al. 1996; McMullan, 1996).

**The Report of the Auditors**

The auditors’ attestation on the financial statements is documented in the Auditors’ Report, which must accompany the financial statements sent to shareholders. The auditors’ conclusion on the statements audited is in the form of an opinion. The opinion rendered on the accounts audited represents the culmination of the audit evidence accumulation process of several stages. At each stage evidence is aggregated and evaluated as to its adequacy and reliability to support assertions made by management (Blokdijk et al., 2002). The auditors also state how the audit was planned and performed to achieve a reasonable level of assurance that the financial statements are free of material misstatements based on the evidence accumulated. The audit evidence accumulated is based on what auditors consider as nature, extent and timing of audit procedures. The planned level of assurance sought and the extent of
In Malaysia, companies may view the Code as another form of compliance required by the regulatory authorities so whether there is any serious buy-in by management to introduce good corporate governance culture is an empirical issue. In this regard the number of resources committed by the auditor and hence the audit fees, in performing the audit, may depend on the auditors’ assessment of the quality of the client’s corporate governance structures. O’Sullivan and Diacon (1994) consider that auditors are uniquely placed to assess the quality of corporate governance in a company and the auditor’s assessment is reflected in the audit fees charged. However, there are only some limited studies on audit and corporate governance in Malaysia (Mohd. ‘Atef and Ayoib, 2002, Ayoib and Rezagalla, 2004). These studies have shown that choice of auditors and audit fees are related to some governance characteristics posited as best practice in the Code. Since the Code describes principles which are to be applied by corporations in a manner appropriate to the particular organization, and the listing requirements mandate a disclosure of how such principles have been applied, it is expected, therefore, that different firms will have different ways of applying the principles but the end results should be compliance with the principles enshrined in the Code. Together, the two modes of compliance will ensure the desired governance culture to be inculcated among Malaysian listed corporations.

Given that the Code has just been introduced and enforced via the Listing Requirements of Bursa Malaysia (BM) effective 2001, the requirement to comply with the Code’s best practice adds a new dimension to the audit risk assessment. The impact of compliance with the Code’s best practices on external audit effort has not been empirically examined. There is also little professional guidance as to how auditors should consider corporate governance when formulating an appropriate audit strategy. Research has shown that weaknesses in governance structures are often associated with lower financial reporting quality, earnings manipulation and even financial statement fraud (Dechow et al., 1996; Beasley 1996; Beasley et al., 2000). The effectiveness of a sub-committee of the board, the audit committee, in particular, has been identified as a critical factor in determining audit effort. Further, Krishnan (2001) documents an association between the quality of corporate governance structure of board composition and board sub-committee composition and the incidence of internal control problems. The quality of corporate governance structure may affect auditors’ assessment of risk of misstatements. In addition, with the acceptance of risk-based auditing standard ISA 400 issued in 1998 and as big audit firms move towards an audit strategy that focuses on business process and business risk (Bell et al., 1997), corporate governance could also affect audit program planning and allocation of staff on an audit job. Therefore audit...
effort may change as a result of governance initiatives implemented by audit clients. Understanding the characteristics of corporate governance in place can, therefore, help auditors plan a more effective and efficient audit thereby improving the quality of audit. Increased risk could lead the audit firm to assign more experienced personal staff to the engagement (Asare et al. 2002). In the literature, only Cohen and Hanno (2000) report on the effect of corporate governance factors on the audit process. How governance affects auditor assessment of audit risk and if so which aspect of governance therefore warrants further study. This study contributes to the literature on audit risk and corporate governance and provides empirical evidence as to whether the external audit scope and role has been affected after the Code was implemented.

The external auditors are bound by the requirements of the profession to perform the audit in accordance with approved auditing standards. AI 400 “Risk assessment and internal control” issued by MIA requires the auditor to understand the accounting and internal control systems of clients so that the auditor can plan how to go about accumulating audit evidence in an effective and efficient manner. Three types of audit risk are identified in the standard: inherent, control and detection risks. Inherent risk is the risk of misstatement taking place assuming there were no related internal controls. Control risk is the risk of misstatement as a result of a weak internal control system. Detection risk is the risk that the auditors’ work failed to detect material misstatements resulting in the issuance of an inappropriate opinion. The standard requires that auditors must first assess the level of inherent and control risk of their clients as a basis for setting the extent of substantive tests. Only after assessing the level of the inherent and control risks will the auditor determine the extent of substantive tests to be performed in order to achieve a reasonable level of audit assurance. Therefore the higher the inherent and control risks, the more work and effort have to be expended to arrive at a reasonable audit assurance level and the higher the audit fees. Studies by Cohen and Kida (1989), Krishnamoorthy et. al (1999) and Davidson and Gist (1996) have shown that auditors are sensitive to control system reliability in planning the extent of audit tests. Under corporate governance the additional monitoring in the form of independent and financially literate audit committees could enhance the internal control environment and better internal control could lead the auditor to perform less work substantively.

The control environment spans the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance to the company. A strong control environment will encompass functions of boards and directors and board committees, management’s philosophy and style and the entity’s organizational structure. Second, internal control relates to segregation of duties, documentation and authorization. By understanding the internal control systems the auditor will be able to identify where material misstatement are likely to occur, consider the factors that affect the risk of misstatements and henceforth design the appropriate audit procedures. Part of the assessment of inherent risk relates to quality of management, in particular their expertise, experience and integrity. Paragraph 12 details many factors affecting the control environment such as experience, knowledge of management, capital structure and the existence of related parties. This becomes the basis for the audit plan. In a study by Blokdijk et al. (2002) on what determines the mix of audit procedures selected by auditors, it was reported that the level of substantive testing reduced when the quality of internal controls was assessed as good. This is in line with Paragraph 47 of the standard, which explains that higher control risk because of weak internal controls will lead the auditor to perform more substantive tests.

Auditing standard AI 240 on Fraud Assessment also iterates the importance of assessing management integrity. Furthermore AT5 on Guidance for Auditors on the Review of Directors Statement on Internal Control requires the auditor to review the said statement in connection with Para 15.24 of Bursa Malaysia Listing Requirements (BMLR) to assess whether it reflects the process directors have adopted in reviewing the adequacy and integrity of the system of internal control.

From the standards issued and described above it can be ascertained that the external auditors’ sphere of judgment should include assessing the quality of the board of directors as part of the internal control assessment process. The standards place in the authoritative literature the implied assertion that corporate governance characteristics, in particular, board composition and board characteristics, are expected to have a significant relation to the quality of financial statements over which the auditors are going to attest. Since it is the financial statements and the financial reporting process that have been the domain of the external audit work, corporate governance characteristics have now become of direct concern to the auditors and form a new audit risk dimension in the overall audit risk model. If the requirement of the standard is implemented, then audit effort should reflect the auditors’ response to governance environment of the client.

The auditing profession has moved in tandem by revising the auditing standards, which in total significantly increase the responsibility of auditors. One such standard is ED/ISA 260: Communications of Audit Matters with Those Charged with Governance. Effective 1.1.2003 this standard specifically addresses the implications for audit when conducted in a corporate governance environment. It
defines what audit matters of governance interest are. Para 2 exhorts auditors to communicate audit matters of governance interest arising from the audit of financial statements to those charged with governance of an entity. Para 5 states that auditors should determine who are the relevant persons charged with governance and Para 11 identifies audit matters deemed of governance interest. However, Para 12 does caution the auditor that the audit of financial statements is not designed to identify all matters that may be relevant to those charged with governance. Hence the standard indirectly shows that a substantial portion of the audit of financial statements is interlinked with corporate governance. This new standard, therefore, extends the boundary of the statutory audit in relation to scope as well as reporting responsibilities beyond that specified in the Companies Act 1965. In extending the boundary of audit it is expected therefore that more audit will have to be performed and as such audit fees may increase.

Para 11 identifies eleven matters specifically related to the audit of financial statements. In essence the eleven factors singly or in combination could pose a potential source of misstatement. The standard focuses on accounting policies and its appropriateness, sources of risks, going concern uncertainties, internal control weaknesses and disagreements with management. Most of these matters have been addressed separately in other auditing standards but are presented together in this new standard because the standard anticipates that governance structures would be in place in audited organizations to which auditors can address governance issues. In accordance with the Code, all listed companies should have in place a governance structure which enables the Board of Directors to exercise objective judgment on corporate affairs, including financial reporting, independent in particular from management. The responsibility for oversight of financial reporting, external auditing and internal control lies with the audit committee. Hence an effective audit committee would put in place a strong internal control environment which ensures the integrity of a company’s financial statements as a good control environment will be able to detect and prevent material misstatements from being reported in a company’s financial statements. This is clearly spelt out in the Code.

Koh (2002) identifies the legal, regulatory and reporting framework which impinges on how companies operate in Malaysia as the pillars of the Malaysian corporate governance framework. These requirements encompass the Companies Act 1965, the Securities Industries Act 1983, the Securities Commission Act 1993, the Malaysian Code on Takeovers and Mergers 1987, the BM Listing Requirements and Practice Notes, Guidelines on the Regulation of Acquisition of Assets, Mergers and Takeovers, the Financial Reporting Act 1997 and the Code of Corporate Governance 2001. These requirements appear as layers of forces that direct, shape and maintain standards of good corporate behavior. The Code is at the heart of the governance framework and in February 2001 Bursa Malaysia (BM) issued Practice Note 9/2001 explaining the contents of the Corporate Governance Statement, which must be included in a company’s annual report. This statement must explain how the Principles in the Code have been applied and show the extent of compliance as detailed in the Best Practice section of the Code. The Corporate Governance Statement must be included in the annual report for financial year beginning July 1 2001. Clearly reforms in corporate governance are regulatory in nature.

From the above discussion, assessment of audit risk may be affected by the corporate governance structure, specifically that of the audit committee, of the corporation being audited. A strong monitoring function would provide greater assurance that controls are operating effectively which should reduce the assessed control risk as a more accountable board and effective audit committee can be a proxy for internal control strength (Collier and Gregory, 1996). There is also potential for a more efficient audit (less extent of tests of details) and more effective (greater assurance of the integrity of financial statements) audit (Goodwin and Seow, 2002). The auditor must therefore recognize and assess the strength of corporate governance and then use this as an input to the audit plans. Ultimately the planned extent, nature and timing of audit tests will affect the evidence accumulated and thus, the quality of the audit. The above changes to corporate governance framework also imply that change will be spread over a time frame. With more reporting standards being adopted, more frequent reporting and greater disclosures may increase the scope of the audit as well. This will lead to more audit effort being expended.

Goodwin and Seow (2002) examined the perception of directors and external auditors concerning the effect of certain corporate governance mechanism on financial reporting and audit quality in Singapore. Directors and auditors are seen to have considerable influence over the accountability of management and the integrity of financial management. In their study, directors are directly responsible for setting the tone at the top whilst auditors through their interaction with audit committees and client management are able to influence the quality of internal control and integrity of financial reporting. Both groups of directors and auditors participated in an experiment using two hypothetical cases and they perceived that the existence of internal audit and strict enforcement of code for directors had a significant impact on the company’s ability to strengthen control, prevent and detect material misstatement and frauds. The results on the strength of the audit committee were mixed. A
strong audit committee was found to have a significant impact on audit effectiveness, on errors in financial statements and on the detection of management fraud. However it was not significant in relation to fraud prevention or strength of internal control.

Cohen and Hanno (2000) was the first study to focus on auditors’ consideration of corporate governance and management control philosophy in preplanning and planning judgments. Like Goodwin and Seow’s study, the authors used the experiment method of data collection. The study involved 96 auditors’ responses to a fictitious case. The results suggest that auditors are more likely to reduce substantive tests in the presence of strong corporate governance. The study finds that companies with independent board of directors and having an audit committee were perceived by auditors to have lower audit risk and therefore will require less audit effort.

In an earlier study Hanno and Aggolia (1999) found that management and governance characteristics were considered by auditors to be the most important factors in the evaluation of the control environment. If the auditor seeks to reduce substantive testing, the level of control risk must be assessed, thus requiring the auditor to explicitly evaluate management and board characteristics. Cohen et al. (2002) conducted a semi-structured interview with 36 auditors on current audit practices in considering corporate governance in the audit process. The findings suggest that consideration of governance factors can affect the auditors’ assessment of inherent and control risks levels, thereby affecting the nature and extent of audit testing, the audit effort. If the corporate governance quality is good, the auditors may subsequently reduce sample size and thus reduce the extent of costly substantive testing. When evaluating the strength of corporate governance, auditors looked at credibility of management and board characteristics as important determinants of the control environment.

O’Sullivan (2000) argues that in a good corporate governance environment, there is greater independent representation on boards of companies. Independent directors require more monitoring to demonstrate their commitment to shareholders and this drives the auditor to do more work. Independent directors will also enhance the auditors’ independence because these directors will ensure that management does not restrict the work of the auditors and therefore the auditors are free to set the scope of their examination. De Angelo (1981) defines audit quality as the twin dimensions of the auditor’s ability to detect material misstatements and having detected the misstatements, to be willing to report such misstatements. When auditors are free to set the scope of the audit, this increases the chance of detecting material misstatements, which therefore enhances the audit quality. In addition the study also included share ownership of independent directors as an additional measure of governance. Based on data of 402 UK companies, the study found that audit fees are negatively related to the proportion of equity owned by non-executive directors and that CEO/Chairman duality has a significant impact on audit fees.

Prior studies measure attributes of good governance in several ways: using board characteristics of size, composition in terms of proportion of independent directors on the board, share ownership pattern, CEO duality, multiple directorships and financial or accounting knowledge and diligence of audit committee members. All these characteristics are similar to those described in the Code to achieve board effectiveness. With the exception of Carcello’s (2002) and Abbot et al (2003) s’ study, the rest only measured the existence or otherwise of audit committees as another governance variable. Both empirical evidence and prescriptive literature concur that corporate governance characteristics set the tone at the top for internal control for audit clients. These characteristics provide cues to auditors as to the reliability of the internal control system in place in an organization. The auditor’s assessment of the corporate governance characteristics will determine the amount of evidence to be accumulated to achieve the planned level of assurance and thus the quality of audit. Hence if listed corporations put in place the principles of good governance, greater accountability is achieved, leading to better internal control environment and therefore less audit risk and less audit fees.

Based on the literature above, the research questions are:

What aspects of corporate governance do auditors think of when they are asked about corporate governance? How do auditors incorporate corporate governance in the planning and conduct of audit? How does it vary across different engagements? How important is audit committee?

Results and discussion

Research question 1: What aspects of corporate governance do auditors think of when they are asked about corporate governance?

In response to this question, all partners agree that the structure, in particular, the lines of authority and functions are at the heart of governance and this is where auditors focus their risk and plan. Highest level of authority in particular, the aspects relating to the financial reporting process sets the tone at the top. “Many times we consider the qualifications and character of the audit committee chairman as very important”. Despite the Code’s Best Practice guide which requires non-executive directors to be a majority of audit committee members, most listed companies are relatively homogenous in structure in complying with the form of audit committee independence. Hence a discriminating factor is
therefore the personality of the audit committee chairman.

Research question 2: How do auditors incorporate corporate governance in the planning and conduct of audit?

Assessment in the initial stages is made using a checklist drawn up based on the Code. Where the initial risk assessment indicates poor governance audit response is to require greater sample size and thus increase the scope of audit work subsequently to reflect greater skepticism. Corporate governance is explicitly considered throughout the audit but for different purposes. At the beginning of the audit partners say it is important to assess engagement risk of accepting client in the first place. Partners agree that assessment is made throughout the audit.

“We certainly constantly review throughout the audit and a revisit is made at the final stage of the audit.”

Research question 3: How does it vary across different engagements?

Partners comment that different engagements have different governance strength. However, an important factor acknowledged is that certain more regulated industry requires a greater emphasis on good governance as part of audit risk assessment especially public listed companies under the purview of Bank Negara.

Research question 4: How important is audit committee?

Partners feel that it depends on who sits on it. In the early years “they allow the CEO to respond now audit committees are more conscious of their duties”. Partners are of the view that it depends on the approach/stance taken by audit committee. A good independent audit committee is an important pillar, supported by executive committee. The most important factor is the CEO.

Some partners consider audit committees very important saying that the power and personality of chairman sets the tone. To be effective, partners feel that audit committee must think of interest of minority shareholders as well.

Research question 5: Has corporate governance made any significant impact on audit process?

Almost all partners said yes. On the positive side it helps mitigate risk exposure of auditors and indirectly helps auditors to do a more effective audit. Corporate governance is seen as the cornerstone and is most important and a significant input in the audit process. There is now more communication and dialogue with directors.

A dissenting voice feels that the level of corporate governance in Malaysia is still low as middle management is still not conscious of the importance of corporate governance.

Conclusion

This paper reports on how Malaysian auditors perceive the impact of governance on the audit process of listed Malaysian companies. Based on interviews with audit partners the study finds that corporate governance assessment is incorporated very early in the process of accumulating audit evidence, when partners assess the risk of accepting a particular client. The audit risk model is versatile enough to enable auditors to incorporate assessment of governance throughout the audit. The audit committee may be the single most important aspect of internal control provided it has the characteristics of independence and competence. Partners agree that corporate governance has an impact on the efficiency and effectiveness of audit more so for highly regulated sectors of finance and insurance. Future studies may consider examining how auditors interact with audit committees and make judgements as to whether audit committees contribute to reducing audit risk.

References

Columbia


