DO EXTERNAL AUDITORS PERFORM A CORPORATE GOVERNANCE ROLE?

EVIDENCE FROM MALAYSIA

by

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ADAKAH JURUAUDIT LUAR MEMAINKAN PERANAN DALAM PENTADBIRAN KORPORAT? BUKTI DARI MALAYSIA.

ABSTRAK

Tumpuan pemilikan korporat telah mencipta konflik agensi antara pemilik-pemilik pengawalan dan pemegang saham minoriti di Malaysia. Mekanisme kawalan korporat yang konvensional adalah lazimnya lemah dalam mengatasi masalah agensi ini. Kajian ini memeriksa sama ada juruaudit luar di Malaysia memainkan peranan dalam pentadbiran korporat dalam mengurangkan masalah agensi antara pemilik pengawalan dan pemegang saham minoriti. Dengan menggunakan sampel syarikat daripada Papan Utama dan Kedua pada tahun kewangan 2007, analisis menunjukkan bahawa firma Malaysia yang mempunyai tumpuan pemilikan yang tinggi berkemungkinan besar mengupah jenama nama, kualiti juruaudit. Dalam analisis yuran audit, kita dapati bahawa di Malaysia, pasaran yuran audit adalah tertakluk kepada peraturan yang telah ditetapkan. Ia menunjukkan bahawa juruaudit luar mempertimbangkan kerumitan pelangganya dalam penentuan yuran audit. Juga, kita dapati bahawa juruaudit luar akan mempertimbangkan tumpuan pemilikan dan keuntungan dalam pelangganya dalam keputusan laporan audit. Selaras dengan analisis pendapat, kita dapati bahawa juruaudit akan mengelak dari hubungan audit yang lama dengan syarikat-syarikat yang mempunyai masalah agensi dan masalah kewangan. Keseluruhannya, kajian menyokong bahawa juruaudit luar memainkan peranan pentadbiran korporat dalam mengurangkan konflik agensi di Malaysia.

DO EXTERNAL AUDITORS PLAY A CORPORATE GOVERNANCE ROLE? EVIDENCE FROM MALAYSIA.

ABSTRACT

Concentration of corporate ownership has created agency conflicts between controlling owners and minority shareholders especially in emerging markets like Malaysia. Conventional corporate control mechanisms are typically weak in containing this agency problem. This study examines whether external independent auditors in Malaysia serve a corporate governance bonding mechanism role to alleviate the agency problems between the controlling owner and minority shareholders which is proxy by the ownership structure of the company. Using a broad sample of Main Board and Second Board Public Listed Companies in Malaysia for the financial year 2007, we found that Malaysian firms subject to greater agency problem indicated by their high ownership concentration, are more likely to hire name brand, quality differentiated Big Four external auditors. In the analysis of audit fees, we find that the audit market in Malaysia is subject to fee regulations and that external auditors take into considerations of the complexity of its clients when making audit fee decisions. Also, we find that external auditors lower the modification threshold as their clients' agency problem increases. Consistent with the opinion analysis, it is noted that low earnings will more likely trigger auditors to avoid long audit tenure with firms that have more agency problems embedded in their ownership structures. Taken together overall evidence lends support to the agency theory and suggests that independent external auditors do play a corporate governance role to mitigate agency conflict in emerging market like Malaysia.

Chapter 1

INTRODUCTION

1.1 Introduction

This chapter introduces the research outline of this study. The chapter illustrates the background, problem statement, research objectives, research questions, significance of the study and major variables of study.

1.2 Background of the Study

According to Accountant's Today, a spate of mini-Enrons has been hitting Malaysia lately, putting key players in the local corporate governance such as directors, managers, accountants, auditors, corporate advisors, Bursa Malaysia, the Securities Commission (SC), and even analysts and business journalists under the microscope. (Abdullah, 2007). The spate of mini- Enrons mentioned above are referring to Megan Media Holdings Berhad, state-controlled lender Bumiputra-Commerce Holdings Bhd, small technology firm Wimems Corp Bhd, and the more prominent case Transmile Group.

The biggest financial irregularities were revealed in the Bursa Malaysia listed air cargo carrier, Transmile Group. According to Accountant's Today, Transmile was alleged to have overstated its revenue by a total of RM522 million in financial years 2004, 2005 and 2006. In addition, RM341 million in its property, plant and equipment account appear to have been fabricated as the amount was little supported by documents. The company was also said to have made payments totaling RM189 million last year and this year, without any supporting payment vouchers. (Abdullah, 2007)

These mini Enron's cases will increase the investors' risks and it would definitely affect the investors' confidence and trust in the audited accounts of Bursa Malaysia's listed companies. Investors would ask, how many similar Transmile case which was not discovered. This has lead to angry investors and minority shareholders voicing and urging the authorities to take tough action on those responsible and to examine the role of external auditors. (Chong, 2007). The loss of confidence would be translated in our economy, as when investors loss trust, they will sell their invested shares and market will react accordingly to the negative signaling effect. All investors would be affected too, hence creating a vicious cycle.

The occurrence of mini-Enron's cases could be due to failure to adhere to the best practices of good corporate governance. Hence, putting the key players of corporate governance especially the external auditors under scrutiny. In Malaysia, a company is compelled under Company's Act 1967 to appoint an external auditor annually to audit its annual accounts. Thus, we can see here that implicit in the mandatory appointment of external auditors by each company is the recognition by the lawmakers that external auditors play a vital governance role to serve the interests of the shareholders. (Ismail, 2007). But how true is this, is still subject to debate by the general public especially after the occurrence of mini-Enrons.

Public question whether the corporate governance mechanism is actually in place amid the recent negative incidents of audited financial statements. Transmile case which detected irregularities back to year 2004 actually worsening the doubt that the public had and wonder why the external auditor gave out a clean opinion way back to financial year 2004, when in actual fact it is not, thus deceiving the investors, especially the minority shareholders. According to PricewaterhouseCoopers executive chairman Datuk Johan Raslan, what happened in the last few months, showed inherent weaknesses in the existing financial system, especially in audit practice. (Danny Yap, 2007). This is alarming as the investors, especially the minority shareholders who depend on the audited financial statements to make investment decision and, having a doubt on this main investment tool is not encouraging news. The occurrence of Mini-Enrons' imply that we Malaysian, seems to forget the lesson learned from the famous Enron Incident that contribute to the collapse of a giant accounting firm, Arthur Andersen in year 2001. It looks like history is about to repeat itself.

The introduction of the Public Companies Accounting Oversight Board (PCAOB) in October 2007 will warrant auditors to adhere to a new level of corporate governance. PCAOB establishment was announced in the recent Budget 2008 by the Prime Minister YAB Dato' Seri Abdullah Ahmad Badawi and the establishment is for the purpose of improving corporate governance under the auspices of the Securities Commission (SC) and the PCAOB will be responsible for monitoring auditors of public companies to ensure that the quality and reliability of audited financial statements are maintained. The setting up of the Public Companies Accounting Oversight Board (PCAOB), which comes into effect on October 1, 2007, is a positive move by the Government to ensure greater reliability of audited accounts, said PricewaterhouseCoopers executive chairman Datuk Johan Raslan. The measures to improve Corporate Governance came on the heels of several high-profile corporate scandals like

Transmile Group Bhd's that had rattled investors and raised concerns over weaknesses in the current system.

Players in the capital market also praised the Government for its speedy action to tighten financial controls, sending a strong signal to those planning to defraud stakeholders that their actions would not be tolerated. Others in the accounting fraternity also welcomed the setting up of the PCAOB and other measures to protect investors. Studies have shown that better corporate governance will have beneficial effects on the financial performance of companies such as higher share prices or lower cost of capital, resulting in an overall better capital market. Companies could be assured of the quality and independence of auditors, as there would a committed board overseeing the function of auditors itself. Accounting firms would now require higher standards of competencies and staff skills that would stick strictly to the rules (Danny Yap, 2007).

The mini-Enron’s cases and the setting up of PCAOB has indicated that the public and government has lost its confidence and trust in the external auditing function. Hence, this study attempt to show whether external auditors play a corporate governance role in Malaysia.

1.3 Problem Statement

As quoted in Accountants Today, 2007, July, p.6 “In 2002, then MIA President Datuk Abdul Samad Haji Alias, in an article in *Malaysian Business,* stated that “mini-Enrons” were happening in Malaysia all the time and to confirm with that, the media has been highlighting cases of corporate reporting gone faulty”. The results are a spate of cases involving companies such as

Transmile Group Bhd, Megan Media Holdings Bhd, Bumiputra-Commerce Holdings Bhd, and Wimems Corp Bhd.

These minis- Enron's cases have transformed investors into becoming, more careful and diligent investors. Decision making information can be obtained from companies' financial statements and the quality of the information will be enhanced by the added credibility from having been audited. (Pound, Willingham & Carmicheall, 1997). This credibility is questionable after the well publicized big corporations like Enron and Worldcom collapsed shortly after an unqualified audit report issued. This has resulted public to question whether or not external auditors are doing their job properly and whether or not they actually play a role in maintaining healthy corporate governance in Malaysia. The undetected irregularities by external auditors until much later actually tarnished the reputation of the profession and the integrity of the auditing profession.

Corporate governance is defined as the system by which firms are controlled and directed (Cadbury, 1992). Theoretical and empirical findings usually consider concentrations of ownership and insider ownership as the main corporate governance concern (Ballesta & Garcia-Meca, 2005). As ownership concentration increases to a level where an owner obtains effective control of the firm, as is the case of East Asia, the nature of agency problems shifts away from manager-shareholder conflicts to conflicts between the controlling owner and minority shareholders (Scheifer & Vishny, 1997).

In emerging market like Malaysia, concentration of shareholding, the domination of control by family members or government institution is a common ownership structure. According to Claessens, Djankov, and Lang (2000), one forth of the corporate sectors of Malaysia is controlled by ten families. Fan and Wong (2001) and (2005) further concurred that in East Asia, agency problem of listed companies in East Asia is closely related to their concentrated ownership structure. Prior research studies consider ownership concentrations as one of the control mechanisms in mitigating agency problem described earlier (Ballesta & Garcia-Meca, 2005). However, this control creates another form of agency problem, the potential expropriation of minority shareholders and other stakeholders by controlling shareholders (Guedhami & Pittman, 2006).

The concentrated ownership gives rise to conflicts of interest between the controlling owner and minority shareholders and this agency problem is difficult to mitigate through conventional corporate control mechanism such as board of directors and audit committees. According to Fan and Wong, 2005, "to mitigate this agency problem, theory suggests that the controlling owners may find ways to employ credible monitoring and bonding mechanisms to assure the minority shareholders that their interests would be protected". Thus, we examine whether external independent auditors play this role in Malaysia Market.

In Malaysia, a company is compelled under Company's Act 1967 to appoint an external auditor annually to audit its annual accounts. Thus, we can see here that implicit in the mandatory appointment of external auditors by each company is the recognition by the lawmakers that external auditors play a vital governance role to serve the interests of the shareholders. (Ismail, 2007). However, the spate of corporate failures, audit failures and financial scandals has led this into a subject of debate among public.

The auditor's responsibility is to express an opinion as to whether the set of accounts gives a true and fair view of the company in accordance with the financial reporting framework and serve as an assurance tools that the financial statements of public listed companies are stated at true and fair view. The duties, scope, rights and responsibilities of the external auditors are spelt out in the relevant sections on Audit and Accounts in the Companies Act, 1965. Investors rely on quality financial information to assist them in making financial decisions and quality audit can enhance the reliability of those financial statements. The attestation of the independent external auditors via Auditors' Report further improves the credibility of the financial information attested to it. However, according to Fan and Wong (2001), whether or not East Asian external independent auditors in practice fulfill the quality assurance role and hence mitigate the agency problem is subjective and still open to debate among general public.

Agency problem arise because of conflicting goals and information asymmetry which creates potential for opportunism (Jensen & Meckling, 1976). This study on whether the external auditors play a corporate governance role is related to agency theory. Agency theory is built on the premise that the interest of the principals (in this case, majority shareholder) and agents (in this case, minority shareholder) are incompatible. In the absence of proper monitoring and control mechanism, majority shareholders would have a higher degree of freedom to use the organisational resources for reasons not acceptable to minority shareholders. (Fan & Wong, 2001, 2005).

This study uses ownership concentrations as the common independent variable for each dependent variables of auditor's choice, audit fees, audit opinion and audit tenure. The theoretical framework and hypotheses development of this study is primarily based on the agency theory as the main concern of the corporate governance is to protect public's interest. Thus, in this study, we examine whether external independent auditors in Malaysia serve corporate governance bonding mechanism role to alleviate the agency problems between the controlling owner and minority shareholders which is proxy by the ownership structure of the company.

1.4 Gap in Literature

There are some gaps in previous literature that drive this study to be carried out to determine the role of external auditors in corporate governance especially in the case of Malaysian public listed company. Firstly, almost all empirical studies conducted in the past have utilized western countries data. The research in the area of corporate governance was initiated in Asian countries only after the Asian financial crisis when the governance structure was reformed. As such, by focusing on data after the governance requirement been established, a clearer justification on the role of external auditors in corporate governance can be drawn.

1.5 Research Objectives

The following are several objectives for doing this research:

- To examine whether external independent auditors in Malaysia serve a corporate governance bonding mechanism role in alleviating corporate governance concern, i.e. the agency problems between the controlling owner and minority shareholders. Specifically this study has few sub-objectives in investigating the corporate governance role of independent external auditors in Malaysia.

  (1) To examine the influence of agency conflicts between the controlling owner and minority shareholders on company's auditors' choice of name brand (Big Four) external auditors or the non Big Four external auditors

  (2) To examine whether external auditors take into account firms' agency conflicts between the controlling owner and minority shareholders when making audit pricing decisions

  (3) To examine whether external auditors take into account firms' agency conflicts between the controlling owner and minority shareholders when making audit opinions decisions

  (4) To examine whether external auditors take into account firms' agency conflicts between the controlling owner and minority shareholders when making audit tenure decisions

1.6 Research Questions

In order to achieve the above objectives, the proposed research attempts to answer the following questions:

a) Does company with high concentrated corporate ownership structure which is a proxy of its agency conflicts is more likely to choose name brand big four auditors to address its agency problem?
b) Does company with high concentrated corporate ownership structure which is a proxy of its agency conflicts is more likely to be charged a higher audit fees by name brand big four auditors as they charge a premium in response to agency problem?
c) Does low earning company with high concentrated corporate ownership structure which is a proxy of its agency conflicts will more likely trigger a modified opinion?
d) Does low earning company with high concentrated corporate ownership structure which is a proxy of its agency conflicts will more likely avoid long audit tenure?

1.7 Significance of Study

This study is important since there are increasing Mini-Enron's cases in Malaysia .The increasing calls from investors and Minority Shareholder Watchdog Group (MSWG) who wants the authorities to take tough actions on those responsible is another factor to consider. MSWG has urged the regulator to examine the role played by the external auditors and take speedy action to bring those at fault to task. By conducting this study, we hope it can shed some light on whether external auditors are actually at work in protecting the public interest.

1.7.1 Practical Approach

This study will contribute to the society in the following practical areas:

- To serve as a reference for relevant parties as this work may be of interest to market regulators such as PCAOB, institutional bodies and large audit firms given the concerns over the regulation and quality of auditing services.
- To provide some background analysis on role of external auditing in Corporate Governance in Malaysia and the result of this study proposal maybe able to restore the faith public used to have on the external auditing profession in safeguarding the public interest.

1.7.2 Academic Approach

This study will make contributions to the academic field as follows:

- To increase understanding on the current corporate governance mechanism by focusing on external auditors' role in company with high ownership concentrations.
- Contribute to Malaysian literature on the role of external auditing in Corporate Governance in Malaysia.

1.8 Major Variables of Study

In order to share common understanding of the concepts and for better understanding of further discussion, the following key terms' definitions were referred specifically.

1.8.1 Ownership Structure as a Proxy for Agency Conflicts

Theoretical and empirical findings usually consider concentrations of ownership and insider ownership as the main corporate governance mechanism (Ballesta & Garcia-Meca, 2005). As ownership concentration increases to a level where an owner obtains effective control of the firm, as in the case of East Asia, the nature of agency problems shifts away from manager-shareholder conflicts to conflicts between the controlling owner and minority shareholders (Scheifer & Vishny, 1997). Agency problem of listed companies in East Asia is closely related to their concentrated ownership structure in contrast with U.S. and U.K. organisations that are typically diffusely owned. (Fan & Wong, 2005). In this study, we will be using ownership characteristics of public listed companies in Malaysia to capture empirically the extents of their agency problems.

1.8.2 Auditor's Choice

In the context of this proposal, auditor choice is referring to the choice between name brand (Big Four) external auditors in comparison with the non Big Four external auditors. The Big Four, is a group of international accountancy and professional services firms that handles the vast majority of audits for publicly traded companies as well as many private companies. It is known, that generally big four auditors reputations are perceived to be more independent and provide better quality than local auditors and the demand for their service should increase in response to the client's agency problem. (Fan & Wong, 2001, 2005)

1.8.3 Audit Fees

In the context of this proposal, audit fees is referring to how much the public listed companies in Malaysia are paying to the independent external auditors in return for the services rendered. It is mandatory disclosures required by Companies Act for companies to disclose in the statutory financial statements on how much the company are paying the external auditors. To further examine the governance role of East Asian auditors, we investigate if external auditors take into account firms' agency conflicts when making audit pricing. If external auditors provide assurance of quality through their superior reputations or if they exert efforts to mitigate agency conflicts, these additional services would be reflected in the audit fee. Thus, we test if *ceteris paribus* auditors charge a premium in response to agency problem.

1.8.4 Audit Opinion

In the context of this proposal, audit opinions are referring on what type of opinions are being rendered by the external auditors. The auditor's responsibility is to express an opinion as to whether the set of accounts gives a true and fair view of the company in accordance with the financial reporting framework. Basically, there are two types of opinions, clean and a modified opinion. Modified opinions or an unclean opinion are not desirable because it may affect the market share price and manager's compensations. Thus, an unclean opinion does not benefit all party in an organisation as it reflects in the company's earnings. Whenever, there is a modified opinion, automatically the reliability and validity of the annual report will be questionable which reduce the confidence level of public external potential and existing shareholders, hence affecting the share price. (Chow & Rice, 1982)

1.8.5 Audit Tenure

In the context of this proposal, audit tenure refers as the time length of how long the external auditors have been servicing its client. Flint (1988) argued that independence will be lost if the auditor is involved in a personal relationship with the client, as this may influence their mental attitude and opinion. One of such threats is lengthy tenure. He contends that lengthy tenure in office may cause the auditors to develop "over-cosy relationships" as well as strong loyalty or emotional relationships with their clients, which could reach a stage where auditor independence is threatened. Lengthy tenure also results in "over familiarity" and consequently, the quality and competence of auditors' work may decline when they start to make unjustified assumptions instead of objective evaluation of current evidence. (Flint, 1998).

1.9 Organization of the remaining chapters

This paper is organized in which the current chapter is the introduction to the field of study proposed followed by an overview of its development. The chapter then defines the problem statement, objectives of the research proposed and questions that is to be answered through the research proposed. The chapter continues with definition of some key terms used in this proposal, the significance of the research proposed and finally the outline of the entire proposal.

Chapter 2 reviews various work of the previous researches related to the topic of this proposal. The chapter ends with the theoretical framework and hypotheses that will be used in the research proposed. Chapter 3 discusses the research methodology proposed for the study. This includes the research design, measures and statistical tests used for analysis of data. Chapter 4 presents the empirical results and discussion. Finally, Chapter 5 summarises the conclusions, states the limitations of the study and provides for future research.

Chapter 2

LITERATURE REVIEW

2.1 Introduction

Claessens et al., (2000) examine the separation of ownership and control in nine East Asian countries, and found that separation between ownership and management is rare due to concentrated ownership in East Asia's corporations. This can be interpreted as that, agency problem arising from management and owner will not be that relevant in emerging economy like Malaysia. However, even though agency problem arising from separation between ownership and management has been mitigated due to concentrated ownership, this gives rise to another form of agency conflicts between the majority and minority shareholders.

Concentration of corporate ownership creates agency conflicts between controlling owners and minority shareholders especially in emerging markets like Malaysia. Conventional corporate control mechanisms such as boards of directors, takeovers and audit committees are typically weak in containing this agency problem. This literature review examines whether external independent auditors could be employed as monitors and as bonding mechanisms to alleviate this form of agency conflict and hence play a corporate governance role in protecting the public interest. (Fan & Wong, 2001, 2005)

Hiring independent external auditors to assure information quality is not a new idea though. Using a historical perspective, Watts and Zimmerman (1983) document that independent audits were demanded since the days of English merchant guilds in the eleventh century to the time when audits were required by law in the twentieth century. Not only is an external audit valued and thus demanded in the absence of law, there is evidence that firms with agency problems are more likely to demand external audits

This literature review relates the corporate ownership structure with mandatory external audits in the context of Malaysian market. We examine the link between auditor-related characteristics of auditor's choice, audit fees, audit opinion and audit tenure and ownership concentration as a proxy of agency conflicts.

These factors as explained in Chapter One above provide quantifiable measures of whether external auditors play corporate governance roles. For better understanding of the present study, a search of previous literature has been undertaken. As such, this chapter was organized in the manner to give an overview of underlying theory, literature review, theoretical framework and the hypothesis development.

2.2 Corporate Governance

There have been many studies and research done in corporate governance in East Asia region, most prominently from the gang of four i.e. Rafael La Porta, Florenzio Lopez-De-Silanes, Andrei Shleifer and Robert Vishny. These scholars assembled powerful new empirical evidence on corporate governance and introduced a new phase to corporate governance research.

In Malaysia, there is an annual Corporate Governance Survey (CG Survey) covering selected public listed companies in collaboration with School of Business, Nottingham University. Raising the standards of corporate governance of public listed companies in Malaysia played an important role to the growth of a healthy capital market of the country. This is in line with the Government's effort to strengthen the corporate governance framework as announced in the recent 2008 Budget in ensuring the integrity of the capital market and securing investors' confidence. The role of gatekeepers of the capital market through the monitoring of corporate governance standards should not be left to the regulators alone and all other market participants must play their part. (Minority Shareholder Watchdog Group (MSGG), 2007)

The CG Survey reinforces the expectations that level of compliance with recommended corporate governance principles and best practices is positively related with firm size, that is bigger companies which arguably have the resources tend to exhibit higher level of compliance with sound corporate governance principles and best practices. It also reveals that the requirements of the Code have been generally well complied with and companies ought to strategies by embracing those principles and best practices not already enjoyed by the Code as a means to differentiate them against others in competing for lower cost of capital and international trade. (MSGG, 2007)

A definition by the Finance Committee on Corporate Governance in Malaysia in the Report on Corporate Governance (2001) stated that: "*Corporate governance is the process and structure used to direct and manage the business and affairs of the company towards enhancing business* *prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking account the interests of other stakeholders".*

This indicates that corporate governance is not only applied to the shareholders but the other stakeholders as well. It affects the development and functions of capital markets and exerts a strong influence on resource allocations due to its reductions in shareholder's monitoring and auditing costs. According to Zulkafli, Abdul Samad and Ismail (2005), the East Asian economies collapsed in the second half of 1997 prompted the discussion on Corporate Governance and it is through this period that greater concern and recognition of Corporate Governance to the public and private sector in those countries were acknowledged.

The failure to regulate good governance affected the mobilizations of funds in effective ways as corporate governance is an important element of achieving an allocative efficiency in which scarce funds are being used in investments that generate the highest returns. (Zulkafli et al., 2005). To concur with the abovementioned, Scheifer and Vishny (1997) mentioned that, corporate governance mechanisms assure investor in organizations that they will receive adequate returns in their investments. Thus, we can conclude that shareholders protection were inadequate during the crisis and as such contributed to the destruction of the value of their investment.

There seems like a consensus that the element of poor governance could not be separated in explaining the abovementioned crisis and as such, like other economies in East Asia, corporate governance has been actively promoted to the Malaysian corporate sector in a period after the crisis. Since then, corporate governance measures have been taken to improve fairness, transparency, accountability and responsibility in running the organizations (Zulkafli et al., 2005).

This literature review will research whether the external auditors play a role in Corporate Governance i.e. in alleviating corporate ownership concentrations, focusing on the Malaysian context.

2.3 Agency Theory and corporate governance

Agency theory is widely used in the economic and finance studies. (Jensen & Meckling, 1976). Separation between ownership and control of corporations characterizes the existence of a firm. Berle and Means (1932) stated that agency problem arises due to this separation. In a corporation, the shareholders are the principals and the managers are the agents working on behalf of the principals. Agency theory assumed that interests of managers are not necessary in accordance with the interest of shareholders. This results in agency problem (Short & Keasey, 1999; Wong & Yek, 1991). The design of mechanism for effective corporate control to make managers act in the best interest of shareholders has been a major concern in the areas of corporate governance (Allen & Gale, 2001). Further research in agency theory attempts to design an appropriate framework for such control. Prior studies consider ownership concentrations as one of the control mechanisms in mitigating agency problem described earlier (Ballesta & Garcia-Meca, 2005). However, this control creates another form of agency problem, the potential expropriation of minority shareholders and other stakeholders by controlling shareholders (Guedhami & Pittman, 2006).

2.4 Ownership Concentrations as a proxy for agency conflicts

We use the ownership characteristics of Malaysian Public Listed Companies to capture empirically the extent of agency problems. Agency problem of listed companies in East Asia is closely related to their concentrated ownership structure in contrast with United States (U.S.) and United Kingdom (U.K.) organisations that are typically diffusely owned (Fan & Wong, 2001, 2005). This is evidence in the study performed by Krishnamurti, Sevic, A. and Sevic, J., (2006), where almost 90% of public listed companies in Malaysia have a controlling shareholder. The study also shows that the mean ownership by three largest shareholders is about 54% indicating relatively high degree of ownership concentration. The mean voting rights of 34% for the typical firm is much higher than the ownership of 28% indicating that the probability of expropriation. Agency problems associated with the separation of ownership and control have been the subject of "considerable" empirical research by Claessens et al., (2000); La Porta, Lopez-de- Silanes and Shleifer, (1999); Fox and Walker, (1998); Johnson, Boone, Breach and Friedman, (2000).

With ownership concentrations, there is potential expropriation of minority shareholders and other stakeholders by the controlling shareholders. As mentioned earlier on, this mitigates the conventional agency problem of managerial expropriation however it creates another agency problem between the majority and minority shareholders (Guedhami & Pittman, 2006). These dominant shareholders usually exert full control over managers and frequently hold control power in excess of their cash flow rights, providing them with strong incentives to extract private benefits at the expense of minority shareholders (La Porta et al., 1999). According to Scheifer and Vishny (1997, p. 758), "large investors represent their own interests, which need not coincide with the interests of other investors in the firm, or with the interests of employees and managers".

Decisions made by controlling owners which are against the minority shareholders interest are not easily contestable by internal and external control systems, i.e., boards of directors and takeover markets, respectively and the controlling owners often will build up their control via stock pyramids and cross shareholdings (Fan & Wong, 2001, 2005). This will result in the shares of the organisations being traded at discount as external investors and ultimately the shareholders (controlling and minority) would have to bear the costs (Claessens et al., forthcoming; La Porta et al., 1999). The agency problem has also been attributed as a key factor that exacerbated the stock market declines in East Asia during the 1997 financial crisis (Mitton, 2000; Johnson et al., 2000; Lemmon & Lins, 2001)

The issue of ownership concentration has been a topic of research since Berle and Means (1932). Further to Berle at. al., La Porta et al., (1999) found that ownership in countries other than United States is more concentrated. Concentration of shareholding is a very common ownership pattern in Malaysia. According to Bursa Malaysia data, Malaysia corporate sector had been highly concentrate in term of ownership where about half of public listed companies had five shareholders owning approximately 60.4 percent of the total equity in the corporate sector. In Malaysia's case, the main reasons of high level of ownership concentration are the prevalence amount of state control and the significant amount of family control in public listed companies. (Dogan & Smyth, 2002).

According to Dogan and Smyth (2002), in Malaysia, the main political parties – United Malays National Organizations (UMNO), Malaysian Chinese Association (MCA) and the Malaysian Indian Congress (MIC), have substantial business holdings. Claessens et al., (2000) using the percentage of shares owned by the largest ten shareholders as a benchmark, reported that the state controlled 17.8% and families controlled 67.2% of public listed companies in Malaysia (as cited in Dogan & Smyth, 2002).

Theory shows that that entrepreneurs requiring external capital would have incentives to mitigate their agency problems by introducing monitoring and/or bonding mechanisms (Fan & Wong, 2001, 2005). An organisation would prefer external financing if the expected benefits exceed the expected gain of expropriating outside investors and may voluntarily employ reputation intermediaries to assure outside investors about their credibility (Fan & Wong, 2001, 2005).

Several recent studies suggest that these ownership characteristics reasonably capture the agency problem in East Asia. (Fan & Wong, 2005). Claessents et al., (2000) report that firm value is sensitive to the largest shareholders cash flow rights and voting rights, consistent with the existence of agency problem. Fan and Wong (2002) report that credibility of East Asian firms' accounting information decreases with agency conflicts, as captured by the firms' ownership structures.

Consistent with Claessens et al., (2000), we will use the percentage of shares owned by the ten largest shareholder of a firm as a proxy for the degree of control. The higher the voting rights of the largest shareholder, the more entrenched is his or her position to expropriate wealth from minority shareholders.

In this paper, we investigate whether independent external auditors can serve a corporate governance role by testifying the quality of accounting information in view of agency problems embedded in the highly concentrated ownership of the companies. We will test whether, the appointment of quality auditors serves as an assurance to the investors that the companies' financial disclosures would be accurate and truthful. The assurance is credible because the auditors, with their reputation at stake, will closely scrutinize their clients' books and truthfully disclose their finding

2.5 Role of External Auditors in Corporate Governance

External auditor is an agent for shareholders and, to a certain extent, also for other stakeholders based on the examinations of the corporate governance promulgations and reports from different interest groups (Holm & Laursen, 2007).

Evidence in a United Nations report, Rahman (1999) calls into question if East Asian external auditors actually serve as monitors. The report queries why many external auditors had issued clean auditing opinions to clients that later went bankrupt within a few months after the completion of the audits at the Asian Financial Crisis. The question whether or not Malaysian auditors in practice fulfill the quality assurance role and hence reduce the agency problem has been a subject of debate, moreover following the Transmile case which was discussed in detail in Chapter 1. If we were to compare to U.S and U.K external audit environment, external auditors in East Asia potentially have a stronger governance role because of weaker legal system in protecting the investors and this is consistent with the fact that the market for external auditors in East Asia is more encouraging (Fan & Wong, 2001, 2005). Generally, in the event of financial reporting failure, investors value legal institutions that discipline auditors. (Guedhami & Pittman, 2006).

It seems like Malaysian government is agreeing with Guedhami and Pittman (2006) with the setting up of the Public Companies Accounting Oversight Board (PCAOB) on October 1, 2007. PCAOB is a board responsible for monitoring auditors of public companies to ensure that the quality and reliability of audited financial statements are maintained