The Relationship between Audit Alumni and Audit Committee

Aufa Amalina Kamarudin

College of Business, Universiti Utara Malaysia

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ABSTRACT

The aim of this study is to examine on how audit alumni can affect audit fee when the alumni be part of audit committee member. Companies must disclose fees paid to the independent auditor in which is the fee fall under audit fees category for the two most recent fiscal years. Other than the “audit fees” category, the company must describe the types of services provided. Audit fee is the exchange given by the company to the independent auditor after conducting the audit work. In nowadays business area, many companies concern about the audit quality that they receive from the auditor’s feedback. It’s being proven by some of the scholars that audit fee will determine the audit quality. One of the main elements that can determine the level of audit fee is audit alumni. Therefore, in this paper I would like to examine the effect of audit alumni towards the audit fee without distorting the audit quality. The paper goes on to analyze a few determinants of audit alumni that can affect the level of audit fee especially when the audit alumni be one of the audit committee members. Audit committee responsible to monitor the preparation of the company’s financial reporting. The findings of the paper include the role of audit alumni in determine the level of audit fee, characteristics of effective audit committee in oversee the preparation of company's financial statement, and the relationship between audit fee and audit quality. Conclusions from the literature are drawn that states that the presence of audit alumni on audit committee can decrease the level of audit fee without reducing the audit quality.

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INTRODUCTION

Both public and private companies’ maxim an intensification in the auditing fees they paid to outside firms, according to a new survey by Financial Executives International. Recently, RSA which is formerly known as Royal and Sun Alliance fronting questions on why the insurer need to pay high NAS services which can lead to the increment of audit fee. Audit fee is a fee that a company pay to the external auditor in interchange for performing the audit work. Building on DeAngelo on audit quality that audit quality are both the ability to discover errors and irregularities and the ability to report such incidence. From preparer’s side, the current regulation in Malaysia mandate that the audit committee is in charge to ensure the quality of financial report conforms to accounting standards. However, in the past few years, several accounting scandals including Transmile Group, Silverbird Bhd, and Satang Bhd had put big questions on the reliability or quality of financial reporting in Malaysia.

External auditor must be an independent person. Highlighted by MIA By-Laws, it discuss on the requirement of independence, “Independence of mind and independence in appearance”. In simplest words, an auditor must free from having any relationship with the company and as possible as can avoid from any conflict of interest.

Audit fee paid by the company is depending on the firm they engaging with. Sometimes a company need to pay high audit fee due to the complexity of audit work face by the external auditor and sometimes the fee is high because the company demand for a higher audit quality. There is a case where the audit firm reduce the audit fee. Reduction in audit fee happens when the firm want to win new clients. This kind of situation happens when audit services market become aggressive. Audit fee behaviour sometimes depends on the environment. Audit committee is responsible to help Board of Director in reviewing and monitoring the preparation of the company’s financial reporting. The use of audit committee is to check and detect the error first before appointing.
auditor to check the company’s financial reporting. Next is, it creates a climate of discipline, risk management awareness and control which will reduce the opportunity for fraud. This will reduce the time taken for the auditor to perform audit services and at the same time can reduce the audit fees.

Lennox and Park, 2007 define audit alumni as the former employee that can bring business to the former employer. Alumni greatest impact is in the process of appointing external auditor to perform audit work for the company. That alumnus will appoint his or her former firm to become the auditor and this will give advantage to parties, client and auditor. The client will get lower audit fee and the auditor (former employer) will have new business. By having such alumni in audit committee, the audit fee seems to be lower than normal [3]. Vermeer, Rama, and Raghunandan, [11] discuss about partner familiarity and audit fees. According to Vermeer et al., audit fees can be reduce to 16% if a company having partner familiarity compare to those without alumni. Audit alumni will somehow create conflict of interest among the alumnus and the external auditor. There is a special relationship between the two parties which sometimes can affect and distort rationale thinking of human being.

2. Problem Statement:

The first problem to be addressed in this study is that some company tend to employ alumni to be part of the company and sometimes hold higher position. This situation will create conflict of interest among the alumni and the audit firm. Avoiding any complication during audit process is the reason why company hiring those alumni. Secondly, fees cutting will lead to the appointment of audit alumni. When audit alumni be part of the company’s committee and become member of audit committee, the audit fee tends to be lower than usual. A possible reason hiring those alumni is to have lower audit fee but still maintaining the good quality.

One of the determinants of having an accounting scandal is the quality of audit work. Audit quality can be criticized when there is an accounting scandal happens. Audit quality derives from the work performed by the external auditor. External auditor will conduct an audit work for a company and as a return the company will pay audit fee to the external auditor. Higher fees paid to the external auditor will contribute to the higher audit quality [5]. Hoitash et al. discuss about the efforts show by the external auditor during the audit work. An auditor will increase the audit effort which can lead to a greater audit quality if the audit fee is high. Support by Griffin and Lont, greater audit quality is when the auditor able to find and detect any misrepresentation of the company’s financial statement. The auditor need to extend the audit time because of the audit risk of the company is high and it can lead to the higher audit fee. Besides helping Board in reviewing the financial reporting, audit committee also presumably strengthens the external auditor’s independence. The existing of audit committee can help in avoiding mistakes happen during the process of preparing financial reporting. As a result, this will reduce the time taken by external auditor in performing audit work. Thus, will reduce audit fee without garbling the audit quality. According to Blue Ribbon Committee an effective audit committee consist member that is independence, possess accounting and financial background, meet frequently in a year, and minimum number of three members on audit committee.

3. Purpose of Research and Research Questions:

This research is to identify and understand the alumni effect towards audit fee especially when alumnus is part of the audit committee member. Previous research solely study on audit committee effect to audit fee. According to BRC, audit committee must comprise a member that is independence member, accounting and financial expertise, meet up at least four times a year, and minimum number of three members and maximum up to seven persons. Therefore, the research questions for this study are:

RQ1: Do independence of audit committee members can increase the audit fees?
RQ2: Do AC members with accounting and financial expertise can increase audit fees?
RQ3: Do AC members that meet up more than four times annually can improve the effectiveness of audit committee and increase the audit fees?
RQ4: Do the size of AC affect the effectiveness and efficiency of their work?
RQ5: Do the AC chairman can affect level of audit fee?
RQ6: Do Audit Alumni can affect the level of audit fee?

The answer to the research questions will be based on the hypotheses testing after collection of the data.

4. Significance of the Research:

From the writing of this paper, we can see that this research contribute in term of knowing what is the use of audit committee in order to get the appropriate audit fee so that it will not burden the company and at the same time it will not harm the quality of external audit work. This study also will discuss about the impact having audit alumni on audit committee and how this alumni at the same time improve the effectiveness of audit committee and reduce the audit fee without reducing the audit quality.
5. Summary of Theoretical Framework:

The main objective of this research is to examine the relationship of audit committee characteristics with audit fee especially when add with the alumni effect. Previous findings found that the more effective audit committee is the more audit fee needs to be paid [10,1]. Nevertheless, there are studies with different findings. Collier and Gregory in 1996 found that audit committee can somehow reduce the audit fee by limiting the scope of audit work which leads to lesser time taken by the external auditor and at the same time reduce audit fee. Audit committee effectiveness can reduce the non-audit services fee. It can compromise the auditor independence. Non-audit services fee is positively related with audit fee [5].

Alumni greatest impact is in the process of appointing external auditor to perform audit work for the company. In this case, the possibility of conflict of interest arise is high. According to Basioudis [3], clients that take the alumni to be someone in their company will pay lesser audit fees compare to the clients that do not employ audit alumni.

6. Literature Review:

Agency Theory:

In order to conduct this study, I use agency theory as the underpinning theory. Agency theory is actually a concept of separation of ownership and management creating a principal-agent relationship. Disclosures being consider as part of the monitoring package to reduce the information irregularity and agency problems with their resulting costs. Yi et al. discuss that stakeholder theory extended the shareholder point of view to include several stakeholders in a relationship between them and the organization. Two parties involve under agency theory which are the principal such as the company’s shareholder and the agent which is the company’s executive. Agent must work for the sake of the shareholder’s benefits but sometimes conflict may arise when both of principle and agent have different goal and both of them have different attitude towards the risk. The agent that being appointed by the principal must represent the principal in transactions with a third party. This is what being discuss under agency theory but somehow in nowadays world, conflict may arise when the rule is no longer being followed.

Audit Fee:

Previous studies have examined the effect of audit committee in determine the level of audit fee. However, the study investigating the effect of audit alumni in adjusting the level of audit fee is still limited in Malaysia especially when the alumni become part of the audit committee members. All companies and groups are required to disclose the statutory audit fees in the notes to the statutory or consolidated financial statements. If the company disclose its audit fees, there is a possibility for the company to reduce dispersion in future [4]. If the company’s audit fee disclosure shows a lower audit fee in a particular year, the auditor may have the ability to increase the audit fee in the following year by giving few assumptions such as previous audit quality is low due to the lower audit fee. Base on the study by Hoitash, Markelevich, and Barragato [5], the increment of audit fee is due to the increase of the auditor efforts to improve the audit quality which been ask by the particular company. Usually, larger company will require the auditor to put more effort and more time require to perform audit work compare to the smaller and medium company. Hoitash et al. [5] discuss the two measures of audit quality which are the proxy is based on the client size and also it’s based on the estimates of expected or normal fees paid to the auditors. Usually, a company with big portion of non-audit services will have higher audit fee [5]. Lenard, Petruska, Alam, and Yu, find a positive relationship between audit fee and non-audit services fee. The same findings by Thinggaard and Kiertzner in discuss that non-audit services lead to more work and thus will increase audit fees.

Audit fee and audit quality is positively related with one another [5]. Yuniarti, discuss that audit fee will affect the audit quality. The higher the fee, it shows the better audit quality. One of the determinants of having an accounting scandal is the quality of audit work. Audit quality can be criticized when there is an accounting scandal happens. Audit quality derive from the work performed by the external auditor. External auditor will conduct an audit work for a company and as a return the company will pay audit fee to the external auditor. Higher fees paid to the external auditor will contribute to the higher audit quality [5]. Hoitash et al. discuss about the efforts show by the external auditor during the audit work. An auditor will increase the audit effort which can lead to a greater audit quality if the audit fee is high. Support by Griffin and Lont, greater audit quality is when the auditor able to find and detect any misrepresentation of the company’s financial statement. The auditor need to extend the audit time because of the audit risk of the company is high and it can lead to the higher audit fee.

Audit Committee Independence:

Audit committee will help Board in reviewing the financial statement and it will help in reducing any errors that occur during the process of preparing financial reporting and this will increase the scrutiny of financial statement, Abbott, Parker, and Peters [2]. Audit committee is a body that accountable in ensuring the quality of
financial reporting and also will help the organization use and manage it resource perfectly. Abbott, Parker, and Peters [2] found that independence of audit committee is negatively significantly related with restatement. Thus, resulting in a lower level of audit fee. Independence of audit committee can increase the independence of external auditor [1]. Abbott et al. argue that by having independence audit committee it will reduce the non-audit services ration thus lead to lower audit fee. Independence audit committee will lower down the dependence of external auditor towards client. When non-audit services decrease, audit fee will also decrease. It is because audit fee and non-audit fee positively relate with one another.

Audit Committee Financial and Accounting Expertise:

Minimizing the possibility of restatement can reduce the audit fee by limiting the substantive test need to perform by external auditor. The existence of a financial and accounting expertise among the members of audit committee can reduce a restatement. On the other hand, Stewart and Kent, [10] discuss that higher proportion of audit committee members possess accounting and financial expertise can increase audit fee. Audit committee with accounting and financial expertise will demand for a better quality and thus lead to higher audit fee. In addition, Stewart and Kent, [10] find that firms with higher audit fees are more likely to use greater level of internal auditing. Usually this kind of firms that engage in greater internal monitoring through the use of internal audit will demand higher audit quality.

Audit Committee Activity:

Audit committee activity is actually the number of meeting held by the committee member in a year. Abbott, Parker, and Peters [2] argued that the minimum number of meetings needs to be held yearly among the audit committee member is four times annually. Thoopsamut and Abbott, Parker, and Peters [2] found that the effective numbers of meeting need to be conduct yearly is four times a year. Four times annually is the minimum number of meeting need to be attended by the audit committee members. Supported by study done by Kang, Kilgore, and Wright in saying that frequently meet of audit committee members will help in early detection of any fraudulent and fictitious figure inside the financial statement and immediate corrections can be take. If the audit committee can detect any misrepresentation earlier, then it can limit the substantive test need to be conduct by external auditor. Limiting the substantive test will lower down the audit fee by reducing the audit hour. Increase in the number of audit committee activity will reduce the audit fee [1], Abbott et al. discuss that effective audit committee can limit NAS purchases.

Audit Alumni:

By having such alumni in audit committee, the audit fee seems to be lower than normal [3]. Vermeer, Rama, and Raghunandan, [11] discuss about partner familiarity and audit fees. According to Vermeer et al., audit fees can be reduce to 16% if a company having partner familiarity compare to those without alumni. Audit alumni will somehow create conflict of interest among the alumnius and the external auditor. There is a special relationship between the two parties which sometimes can affect and distort rationale thinking of human being. According to the study by Basioudis [3], there is an ‘alumni effect’ in the market of audit services if the client takes the alumni of the audit firms to hold high position in their company such as executive directors. Those clients that take the alumni to be someone in their company will pay lesser audit fees compare to the clients that do not employ audit alumni. Besides that, the company also can have proper plan of external audit work.

Support by the study done by Law in 2010, he discuss that those alumni are well known with the design of the audit work and can prepare a good plan of audit work. Usually, companies can predict the audit fee of their companies for three years ahead. The trend of the audit fee will not drastically change in one year and if there is a changing in the audit fee trend, the changes is not big. There is only a few things lead to the changing in audit fee and one of it the present of audit alumni on audit committee. The other several things that lead a company in having unexpected audit fee are when the company involve in acquiring other business and merging activities. Clients that take the alumni to be someone in their company will pay lesser audit fees compare to the clients that do not employ audit alumni. Besides that, the company also can have proper plan of external audit work.

7. The Methodology and Model:

The main approach used in the present of this study is quantitative because the research questions aim mainly to find the relationships among the variables. Specifically the goals of this study are to know the relationship between the effect of audit alumni on audit committee and audit fee. The purpose of this research is to know how far the existing of audit alumni on audit committee can affect the level of audit fee. In this study, I want to see the extent of cause and effect between the independent variables which are audit committee independence, audit committee size, audit committee activity, audit committee expertise, and audit alumni with the dependent variable so call as audit fee. The data of the present study will be collect via secondary data which is from the annual reports of the company and also the proxy statements. From the information that will be
collect by both annual reports and proxy statements, I will gather all the information in this study about audit alumni and also audit committee. Nevertheless the information about audit fee will be gather using the information disclose inside the company’s financial statement.

Using secondary data, I will gather the company’s information on audit fee for three years starting the year of 2011 (before the MCCG 2012) until 2013. From this, I also can see the effect of Malaysian Code on Corporate Governance (MCCG) 2012 implementation. In order to conduct this study, after excluded Banking and Finance Industry, financially distressed companies, and companies without adequate financial information, the sample size for this study is around 500 companies. I will use theory of the pricing of audit services by Dan A. Simunic in order to examine the level of audit fee for the three recurring years.

8. Findings from Literature:

   Literature review was useful for understanding the topic of this research. For this study, I posit SIX (6) hypotheses which are:
   H1: Audit committee independence is negatively significant related with audit fee.
   H2: Audit committee expertise and audit fee is positively associate with one another.
   H3: Audit committee size and audit fee have ambiguous relationship.
   H4: Audit committee activity and audit fee have positive relationship.
   H5: Audit committee chairman is positively related with audit fee.
   H6: Audit alumni are negatively significant related with audit fee.

Conclusions:

   In conclusion, there is an alumni effect in altering the level of audit fee. Demanding for higher audit quality will lead to higher audit fee due to the difficulty of audit work. The existence of audit alumni will somehow reduce the audit fee without reducing the quality of audit work.

REFERENCES