



## The Effects of Politically Connected Audit Committees on the Audit Process: Evidence in Malaysia

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### Abstract

*This study aims to contribute to an understanding of politically connected audit committees on the audit process in an emerging market, namely Malaysia. The study seeks to examine whether politically connected audit committees have an impact on the audit process. An in-depth analysis of the interviews from the external auditor, audit partners and audit committees further reveal that political connections do affect the audit process. It appears that the existence of political connections leads to an increase in audit work such in a variety of ways, such as auditor-client negotiations, private meetings with audit committees, re-engineering the scope and planning of the actual audit work. One of the issues that emerges from these findings is that companies highly value political connections to obtain external resources given the uncertainties in the business environment. The findings highlight the need for stronger corporate governance to mitigate the higher audit risks in such companies.*

**Keywords: Audit Committee, Auditing, Political Connections**

**JEL classifications: M410, M420, M480**

### 1.0 Introduction

A recent strand of the auditing and accounting literature has investigated a number of studies which investigate how political connections of the client companies affect their performance, the audit pricing, the quality of accounting information and the director's remuneration. Various studies examine corporate political connections within a country, Fisman(2001) for the case of Indonesia, Johnson and Mitton(2003) for the case of Malaysia, Ferguson and Voth(2008) and Niessen and Ruenzi(2010) for the case of Germany, and Agrawal and Knoeber(2000) for a sample of outside directors in the United States. Their investigations are shaped by the institutional structure of the country including the country's legal/judicial system, social and political economy.

With regards to the above, this paper focuses on Malaysia and considers the impact of political connections on client companies on their audit process. More specifically, this study examines the response of auditors in terms of audit process of politically connected firms

using politically connected individual on audit committees. This is due to the polemical debates about the rationale behind the appointments of connected individuals in the existing literature, especially in emerging economies, as there is much evidence which has been extensively documented with regards to the appointment of well-connected individuals to directorships (Faccio et al.2006a; Gomez and Jomo1997) have been subject to controversy.

#### **1.1 Political Connections Definition**

The present paper extends the operational definition of political connections in studies by Abdul Wahab et al. (2009), Johnson and Mitton(2003), Faccio et al.(2006a) and Gul(2006) through looking at individuals who are on the audit committees. It deals mainly with the proportion of the audit committees who are politicians (ACPOL) and senior government officers (ACSGO) to reflect the political connections in public listed companies. Previous studies, meanwhile, use a different measure of political connections, such as government ownership and golden shares giving special rights to the government (Gul2006;Faccio et al.2006a). Moreover, prior studies



(Faccio et al. 2006a; Gomez and Jomo 1997; Fisman 2001; Johnson and Mitton 2003) are based on the list of companies with political connections released by Gomez and Jomo (1997) in recognizing politically connected firms. Specifically, Johnson and Mitton (2003) rely on the analysis of Gomez and Jomo (1997) in coding political connections by identifying major shareholders in the firms who have close relationships with key government officials, primarily Tun Dr. Mahathir Mohammad, Tun Daim Zainuddin and Anwar Ibrahim at that particular time. However, the limitation of this measurement is that the connections could have disappeared prior to the crisis and might not be relevant in the current situation.

### **1.2 The audit process**

The audit process can be defined as the activities of auditors who typically assess the risk of material misstatement in the client's financial statements during audit engagement planning. Based on this understanding, the study tries to gain an insight into the influence of political connections on auditor planning and the factors that have been the focal variables for a stream of research, predominantly experimental in nature, investigating their effect on auditors' decisions to assess their clients.

In particular, the current paper focuses on auditors' experiences with the current governance structure which is in line with an effective monitoring approach, as highlighted by Neal et al. (2009) and Cohen et al. (2010). Moreover, the present paper incorporates elements of political connections to capture auditors' experiences with respect to the audit process and corporate governance in the Malaysian setting. Prior studies provide strong evidence on audit committee effectiveness, with improved financial reporting quality (Abbott et al. 2004; Klein 2002; Bedard and Johnstone 2004). The present paper, however, extends the prior research on these important issues in two ways. First, the review of the literature on audit committee's notes that audit committee independence enhances their effectiveness and is associated with improved reporting (Norziaton et al. 2015; Johl et al. 2012; Abbott et al. 2004; Collier and Gregory 1996). However, the audit committee or boards of directors are not fully independent if they are politically connected, as viewed from the experiences of the auditor, which is the focus of the present study. Further, there is a lack of evidence on other significant dimensions, such as the audit process and the auditor's integrity in conducting audits with these types of connections. The impact of politically connected audit

committees /boards on the audit process is a potentially fruitful area to investigate.

### **1.3 Institutional Setting: Malaysia**

There is unambiguous evidence that political connections bring in benefits and costs to firms. However, a major problem with influence through political connections, as highlighted by Johnson and Mitton (2003), is that politically connected firms are perceived by the market to be inefficient which causes a lack of support for this type of firm from the government. Following from this issue, Malaysia introduced a Code of Corporate Governance (MCCG) in 2000, revised in 2007 and 2012. The impacts of these efforts on audit committee effectiveness and political connections have not been examined in prior studies, as these studies on politically connected individuals are still very scarce in the literature. The research to date has tended to focus solely on audit committee effectiveness (Abbott et al. 2004; Haniffa et al. 2006c; Vafeas 2005) and has neglected the impact of political influence in the unique economic setting of Malaysia since political connections play a very important role in the corporate sector. There is increasing concern about politically connected firms being perceived to exhibit poor corporate governance, greater agency problems and higher business risk (Wahab et al. 2009; Gul 2006). The key problem that needs to be highlighted is that Malaysia itself is a country that is based on a relationship based economy which businessmen tend to develop ties with the political individual (Bliss and Gul 2012b; Fraser et al. 2006).

### **2.0 Purposes of the Study**

The study enhances our understanding of the obscure side of the work of auditors the leeway they have in performing their duties. This aspect remains almost unexplored by researchers, because it is difficult to have access to both external auditors and internal auditors, and because their work remains confidential for strategic reasons (Neu et al. 2013). The study enhances the prior studies by exploring in depth the practice and perceptions of the external auditor on their experiences and their way of coping with the political connections issue. This is necessary because role conflicts are at the core of their practices in planning the scope and plan of an audit (Vinten and Van Peurse 2005; Norman et al. 2010) and may have an impact on the roles that they ultimately play within the organization (Roussy 2013). This study illustrates whether political connections may influence an auditor's coping behavior and may affect their ability to perform



their governance duty. Hence, the research question is as follows:

RQ: Do politically connected audit committees have an impact on the audit process?

### 3.0 Literature Review

#### 3.1 Politically Connected Audit Committees and the Audit Process

There has been a lack of academic research on how politically connected companies may affect audit quality or the audit process. The political connections of firms may potentially lead to an increase in the complexity of the audit process. There are many factors that auditors must consider, such as personnel policies and procedures, the board's profile and background, and corporate governance information of the firm (Messier Jr and Austen 2000). Prior research by Agrawal and Knoeber (2012) has shown that larger political donations are associated with poorer corporate governance and that donations are indicative of agency problems within a firm. The study specifically found that firms with larger boards, and CEOs who also chair the board, are associated with larger donations. Thus, these political donations may potentially increase the audit process.

Auditors are required to make independent judgments about financial statements from an ethical perspective. Given the complexities of human nature and the involvement of political connections, it can be ethically difficult for the auditor to conduct the audit process. A review of the audit literature has revealed that there are not many studies that have examined how auditors conduct their audit process when political connections are involved. The audit process may potentially involve the audit plan, audit scope, and procedures, ethical action or aspects of behavior in how the auditor responds to ethical situations. For instance, Falk et al. (2000), using an experimental approach, found that when auditors were faced with the prospect of losing a client, they were more likely to compromise their independent judgment. Similarly, Ponemon and Gabhart (1990) found that auditors with low moral development appeared to be more willing to underreport time. These studies, therefore, show that contextual factors (client pressure) may influence auditors' ethical actions. There are also studies on the factors that may influence auditors in conducting the audit process for such instances (Shafer et al. 2001; DeZoort and Lord 1997; Thorne and Hartwick 2001; Trompeter 1994). The

factors that are mentioned in these studies are individual characteristics, internal factors in firms, client company factors and regulatory factors. The present study thus tries to establish if political connections can be among the contextual factors that may influence the audit process.

The book, *Behind Closed Doors: What Company Audit is Really About* (Beattie et al. 2001), used a detailed case study covering audit interactions between finance directors and audit engagement partners (AEP). The study aimed to develop a grounded theory to explain what key factors influence the decision-making process when an auditor is confronted with difficult and contentious accounting issues. The case studies were identified from a previous questionnaire conducted by Beattie et al. (2001), in which respondents were asked whether they were willing to be interviewed. The basis of the present study can be viewed as similar to Beattie et al. (2001), where the difference is that it takes more pronounced look at the influence of political connections in the relationship based market system in Malaysia, compared to the UK which has a less litigious environment, and thus makes research of this nature still possible.

### 4.0 Research Design

#### 4.1 Sample

According to Corbin and Strauss (2008), data collection using theoretical sampling can help the researcher to identify concepts and themes pertinent to the research problem. In this study, theoretical sampling was used to select the interviewees using two sequential phases. In the first phase, targeted groups of interviewees were identified (practitioners). The interviews targeted: (i) external auditors (ii) audit committee members. These targeted people are beneficial to the study as the objective is currently to understand how political connections may potentially affect the audit process. The insights gained from the interviews with a sample of auditors from Big four firms are used to further examine the impact of political connections on the auditing of financial statements. Auditors were selected because they play a very important role in assessing a company's financial statement and they act as a mechanism for limiting agents' opportunistic behavior (Haniffa and Cooke 2005). For this study, among other interviewees, were the selected audit partner or audit managers of Big Four firms in Malaysia. These individuals were chosen because they are considered to be responsible for monitoring audits of



financial statements, and have been directly involved in auditing processes based on their assigned auditors.

In the second phase, after the targeted groups were identified, the researcher communicated with the targeted candidates to check their availability. The researcher used telephone and email to communicate with them, and provided an offer letter explaining: (i) the objective of the study, (ii) the purpose of the interview; (iii) information about the researcher and the university; (iv) the time required for the interview and (v) how confidentiality would be ensured.

**4.2 Background Information of the Interviewees**

A summary of interviewees’ backgrounds, including age, education, current and previous positions, and years of employment in their companies is shown in Table 1 (Appendices 1) for external auditors and Table 2 (Appendices 2) for audit committee members. From these tables, it can be seen that the majority of the interviewees

are aged 33 years old and above, from which it can be inferred that they are relatively experienced individuals. Nearly all have a degree at bachelor’s level or higher, with a few of them having professional qualifications. For this group, based on information about their previous positions, their professional experience implies their personal values, knowledge and skill base have been completely shaped by their educational background. About one-third of the interviewees have been in their positions for five years or more and the majority of them have worked for the same company for more than five years. Positions held by the interviewees prior to joining their respective companies, along with the other background information just discussed, indicate that the interviewees have a significant amount of knowledge of and experience with the issues examined in this study. The following sections present the results of the interviews.

**Table 1: Summary of the Final Sample of Semi-structured Interviews (Audit Partners and External Auditors)**

	Name	Interviewee Designations	Age	Working Experience	Academic Qualifications
1	AP 1	Audit Partner	39 years old	16 years	ACCA <sup>1</sup> ,MIA <sup>2</sup>
2	AP 2	Audit Partner	43 years old	19 years	ACCA,CPA <sup>3</sup>
3	AP 3	Audit Partner	38 years old	16 years	ACCA,MIA
4	AP 4	Audit Partner	47 years old	18 years	ACCA,MIA
5	EA 1	Audit Supervisor	30 years old	7 years	ACCA,MIA
6	EA 2	Senior Manager Auditor	28 years old	6 years	ACCA
7	EA 3	Manager	28 years old	6 years	ACCA

Notes: AP = Audit Partner; EA=External Auditor.

<sup>1</sup> ACCA is the Association of Chartered Certified Accountants and the global professional accounting body offering the Chartered Certified Accountant qualification.  
<sup>2</sup>Malaysian Institute of Accountants (MIA) is the umbrella body for the accountancy profession in Malaysia. It was established under the Accountants Act, 1967, to regulate and develop the accountancy profession in this country.  
<sup>3</sup>Certified Public Accountant (CPA) is the title of qualified accountants in numerous countries in the English-speaking world.



**Table 2: Summary of the Final Sample of Semi-structured Interviews (Audit Committee Members from Listed Companies)**

No	Interviewee Designations	Age	Working Experience	Academic Qualifications
1	AC 1	58	30 years' experience in banking, financial management and accounting.	Bachelor of Finance, ICAEW
2	AC 2	45	18 years' experience in a Big Four firm.	Bachelor of Commerce, ICAEW
3	AC 3	59	Director in a few public listed companies and several other private limited companies.	ACCA, MICPA <sup>4</sup>
4	AC 4	48	15 years' experience in the oil and gas industry.	Bachelor of Science degree in Management (majoring in Finance and Economics), alumnus of Stanford Executive Program, alumnus of Corporate Finance Evening Program.

Note: AC= Audit Committee

<sup>4</sup>The Malaysian Institute of Certified Public Accountants (MICPA) has been developing the accounting profession in Malaysia by providing accounting graduates with an avenue to become Certified Public Accountants, better known as CPA, since 1958.



## 5.0. Findings and Discussion

The findings from the interviews confirmed the presence of political connections through the appointment of politicians and senior government officials to the boards of companies and through companies in which the government owns the shares. In addition, it was found from the interviews that political connections exist in numerous ways. For instance, government projects are among the helping hands allowing companies to survive in the corporate sector. This is evidenced by prior studies (Faccio et al. 2006b; Fraser et al. 2006; Gomez and Jomo 1997) that there is a close link between business and politics in Malaysia. In the next section, the findings from the interviews are further discussed according to the sections and themes that have been recognized during the data analysis.

### 5.1. Auditor Experiences in Politically Connected Companies

Following the question related to board participation, the interviewees were asked, based on their experiences, if they have ever audited politically connected companies. The current study uses the presence of any politicians or senior government officers with positions on a company's audit committee or board, as an indicator that the company is considered as politically connected. The interviewees were asked how they potentially recognized the existence of political connections in the companies that they have audited, based on their experiences.

As one respondent (EA1)<sup>5</sup> said:

*I think yes. I mean, when I went through the whole auditing process, finally I realised, yes; I can say they are kind of politically connected companies. I can give you a few examples of how I probably recognised that. This one is obvious; as sometimes I can see that the relationship among them in the companies is based on their personal connections. They choose their own men, a supporter, to be part of their team in these companies. For example, when someone influential is appointed to the company (politicians), we can confirm their appointment as CEO or BOD, and we can see or check from the date of appointment with the Malaysian Registrar of Business. (EA1).*

As auditors, they need to preserve the integrity of their profession. However, it appears to fuel the satisfaction of management who hired them, to just follow what they are being asked for. The auditors were willing to just agree in order to uphold the integrity of the profession and of the audit firm, and to maintain their independence. This may support Kant and Paton's (1964) deontological view that there are issues that are inherently right or wrong, since one has a duty to do what is right. Thus, the strong power connection may cause unwillingness on the part of these respondents to report questionable acts within such companies.

#### 5.1.1 The Auditor Client Negotiation Process

Some audit partners reveal a variety of auditor client negotiation positions when it comes to political connections and dealing with influential individuals during the audit engagement. In a much stronger position, political connections may have an influence upon negotiations and may take the lead in deciding what to expose, which audit scope to embark on and also become involved in risk management decisions. Gibbins et al. (2000) discusses the auditor client negotiation as an important part of the process of producing the client's accounting information for the use of third parties.

As one audit partner (AP3)<sup>6</sup> mentioned:

*I got involved with this one particular government entity which, during that time, was highly problematic, as we had to have some extra negotiations among the partners and the board. As the company was also funded by the government, we thus had to deal with many people. We need to look at our testing procedure, control process or a similar percentage within the strategy. So we have to look at everything, like their customers, clients, and suppliers. So the negotiations process involving someone or companies that are influential in the government reflects public sector practices and these negotiations somehow give complexity to the team but this does not affect our credibility as an auditor. (AP3)*

In the presence of political connections, the board or AC are likely to be candid with the engagement of auditors, and with sharing and discussing significant matters related to the audit and the financial statement. Thus, the auditor

<sup>5</sup> Interview with External Auditor (EA1), 7<sup>th</sup> March 2017.

<sup>6</sup> Interview with Audit Partner (AP3), 13<sup>th</sup> February 2017.



client negotiation process provides an open door in which Rennie et al.(2010) find that the openness of communication by the client's management representative is essential for the efficient and effective conduct of an audit. In a similar vein, the auditor's trust in the audit committee members, who are socially connected with them, would enable the auditor to obtain the audit committee's insight and information about important transactions and managers 'incentives, leading to a higher audit quality.

### 5.1.2. Culture and Mentality that Set the Tone of Corporate Governance

Previous research finds that contextual factors outside the control of the auditor, such as firm culture (Krishnamoorthy and Maletta 2012;Lampe and Sutton 1994;Margheim and Label 1990), affect the audit process and subsequent external auditor reliance on the internal audit function. Management's attitude sets the tone for governance (Cohen et al. 2002) and the findings of this study indicate that the tone at the top, if it is the culture of a politically connected individual, will filter down through the layers of the organisation. The interviewees identified a few elements originating within organisations and from the external business environment that reflect the existence of political connections. From the interviews, evidence shows that the two most commonly discussed elements are culture and mentality in this kind of environment. The mentality associated with political connections includes respect from the board, audit committee and senior management, which filters down and affects the mentality relating to the audit process shown by the management and auditees, the status of the audit within the organisation, the importance and value of the audit as part of an organisation's corporate governance and the organisation's culture in embracing improvement and change.

The mentality aspect of an organization is seen by the interviewees to be driven by the tone at the top with respect to the audit process. The following supports this:

*I have audited one government-linked entity, and the CFO, he basically understands the whole audit plan that I have presented to them. During the first year, he joined the meetings and he seemed ambitious to change the world and mentioned that I could do it differently. But now, they don't seem to care. I think, because of the mentality in this environment, cost accounting has become like the cost centre, so you don't need an extra budget to invest in computerizing the system. And you can see the senior management does not see the significance of that and the accounting function is not important in their agenda. So, since the government has always allocated an amount of budget or funds to them, they have not been concerned about any other material issue that may arise from their current practices. (AP4)*

One external auditor expressed a similar view, indicating that the 'human' mind-set, in fulfilling the individual's interests and priorities, is being diverted due to the mentality and culture embedded within the organization. Thus, auditing politically connected companies should establish any potential conflict of interest that may threaten the independence of auditors, as follows:

*I definitely have experience of audit committees not necessarily taking all these issues responsibly. I think the boards of directors aren't active and their independence, in practice, isn't applied efficiently. The reason behind that is a majority of shareholder companies are managed by families. Although these companies are pioneers in their industry and their performance is successful, the problematic issue is that the board's first priority is to fulfill the family's interests in terms of profitability and increasing their wealth (EA3)<sup>7</sup>*

From cultural point of view, auditors also must acknowledge that Malaysian political culture is a 'soft' culture, where someone will hardly have a different view from those who are respected and have influential personalities (bosses and senior management). This is supported by Barr (1999), who states that Malaysia's

<sup>7</sup> Interview with External Auditor (EA3),12<sup>th</sup> February 2017.



mainly consisting of Malays, was compounded by the continuing socio economic problems, reflected by their cultural defects, as they had grown up in a 'soft culture' which did not encourage enterprise and hard work, only the following of leaders without saying 'no'. This culture is embedded in both public and corporate culture; therefore, auditors must acknowledge it, despite being independent. The ability of one individual to influence the power relationship between the board, AC members and the external auditor is a function of the standing, quality and experience of that particular individual. Thus, it is becoming crucial, suggesting that the political connections element in companies is a critical factor influencing governance outcomes.

## **5.2. Do Political Connections Potentially Affect the Audit Process?**

In relation to the audit process, the interviewees were asked if the existence of political connections might affect the audit process. They were asked if there are any obstacles or issues regarding political connections that may impair their effectiveness in during the audit engagement. The auditors were asked to provide information on their experiences and perceptions regarding those parties that have greatest influence on the audit process. This question was asked because Cohen et al.(2010) give evidence showing that during the planning and testing phases, 97% and 50% of auditors have changed the process over the last five years with respect to the corporate governance information received by them. It is important to note how auditors respond to the risk of political connections and incorporates them into their audit planning. In addition, during this part of the interview questions, the researcher kept reminding the interviewees that the measurement used to define political connections is through politically connected audit committee in guiding them to answer objectively.

One of the audit partners (AP1)<sup>8</sup> replied:

*Anyhow, I can see there are some obstacles that we are facing in terms of getting further information. I still remember when I audited one GLC; it is like the information given depends on how the BOD perceive its implications. I mean, they tend not to disclose more information if it is not necessary because, I think, they think once they say more, they will be facing political implications from it. Most companies are making efforts to manage any political risk,*

*but most are not doing it as well as they think they should. (AP1).*

### **5.2.1 Compromise as a Solution to Conflict**

The question of whether politically connected audit committee may affect the audit process was posed to the interviewed partners. Most of the partners suggested that compromise was a way to deal with politically connected individual in the companies. Some of the interviewed partners suggested that compromise with the client's management was a reasonable way to resolve any political issues or audit conflict. The definition of compromise in this situation is explained further as involving a variety of negotiation processes, with the partners preferring to view the situation on a case by case basis. However, McNair (1991) found that audit quality and integrity declined. The researcher found that ethical ambivalence existed in audit firms where auditors learnt to compromise truthful reporting and integrity, thus trading off audit quality for business considerations. Although the interviews revealed serious abuse of auditors due to political connections, auditors 'careers rely on their ability to maintain their clients.

An audit partner (AP3)<sup>9</sup> claimed:

*Anyhow, when companies appoint a politician as CEO or to the board of directors, however such appointments work twofold: they may increase the reputation of companies for less governance and may decrease the board's independence. We used to receive letters from politicians and government officers instructing us what to do with the audit report. Usually this happens. They ask us not to disclose such information. It all depends on our senior management. Usually we did not disclose to the public reports like that. (AP3).*

### **5.2.2. Non-routine Audit (Private Meetings)**

Private or personal meetings are held between audit partners and external auditors and the audit committee, usually by the latter's initiative, which help to encourage more compromise and provide a comfortable environment to raise any concerns. Similarly, Gendron et al.(2004) provide insights into practices that audit committee carry out in meetings, including parts of meetings in which members meet privately with the auditor. Their results highlighted that audit committees are generally perceived as effective by the individual who attends meetings, since

<sup>8</sup> Interview with Audit Partner (AP1), 9<sup>th</sup> February 2017.

<sup>9</sup> Interview with Audit Partner (AP3), 13<sup>th</sup> February 2017.





during the meetings they discuss crucial issues, such as accuracy of financial statements, effectiveness of internal control, and quality of work performed by the auditors. In practice, it seems that during private meetings the external auditors only really tackle issues they plan to raise during the official meetings. The external auditors are simply giving their message in advance in such situations, although more directly; the messages are more easily understandable. These meetings are thus a means for them to prepare their questions for the following official meetings. It is also interesting to underline that, even when the external auditors do not choose to play a discrepant role, the simple fact is that politically connected individuals may influence the discussions. This suggests that the auditors have to involve non-routine audit when it comes to political connections, as the private meeting and auditor client negotiations process becomes a tool for compromise.

An audit partner (AP4)<sup>10</sup> stressed that:

*And one thing is having a discussion in the privacy of the audit committee. But once you start putting that in the public domain, then people can challenge it and that makes AC members a lot more conscious about what they are saying. After all, we need to be careful about what we are doing and exposing to the public. (AP4)*

The audit committee member (AC1) claimed that the individual politician may become a tool to compromise things, as he added:

*It can be, yes; and it may not, but after all, we work for the companies in satisfying the shareholder, so doing our job right and ensuring that everything is done accordingly. It is very subjective to say it, because people come with many attributes, being someone influential, outstanding, but the company itself has the control to govern this issue. (AC1).*

### **5.2.3. Auditors' Voices on Highly Independent and Professional Judgment**

When auditors conduct the audit process, the formation of a highly professional judgment requires internal cognitive processes that are affected by external factors, such as client characteristics; for example, the effect of the item on the client's earnings (Johnson et al.1989). In this study, political connections may be one

potential external factor that can affect professional judgment. Thus, one external auditor (EA1)<sup>11</sup> warned that:

*Companies work to a tight reporting timetable and they announce the dates when the financial reporting statements are going to be published. What happens in practice is, management prepares financial statements and the effectiveness of audit committee members depends a lot on what stage in the process they are brought in. If it's too late in the process, then there is a lot of pressure on boards, but particularly on ACs to just 'pass' and not necessarily challenge this deeply. So, when the board puts on the pressure, it may involve lots of hands in the process. (EA1)*

This is supported by another external auditor (EA2)<sup>12</sup>:

*There is a little difference between us when dealing with this kind of issue, for example, from audit scope. We are more detailed and advanced and we need to carefully consider many things from the company's background, board profile, their influences, their reputations, all activities in and out, so that what is there in the companies is publicly reported. We need to highly maintain our independence at the highest level to meet a client's need, as well as our reputation as a high quality auditor. (EA2)*

These interviews gave a voice to the auditors about political disclosure in their situation of maintaining independent judgment when dealing with a powerful client's management. In dealing with highly politically connected companies, most of the interviewees agreed highly independent individuals need to have strong integrity and personality, regardless of where they work. This view is consistent with the factors reported by Flint (1988), who mentioned that independence depends on the auditor's qualities, which include integrity, objectivity and strength of character.

The high degree of independence of an auditor is agreed in the interview of one of the audit committee members (AC1)<sup>13</sup>:

*So it is a common issue for auditors and internal auditors. So, in other words, if you move towards management, it hurts because the board or the*

<sup>11</sup> Interview with External Auditor (EA1),7<sup>th</sup> March 2017.

<sup>12</sup> Interview with External Auditor (EA2), 10<sup>th</sup> March 2017.

<sup>13</sup> Interview with Audit Committee member (AC1),25<sup>th</sup> March 2017.

<sup>10</sup> Interview with Audit Partner (AP4),5<sup>th</sup> March 2017.



*audit committee gives you a hard time due to political interests if any; if it goes the other way, management doesn't like you. It is not that wrong to have politicians in companies, so how this political influence may at a certain point become an obstacle to the auditor, it comes down to the independence of the individual and/or the firm. (AC1).*

### **5.3. Auditors' Perceptions on the Benefits and Costs of Political Connections**

In addition to examining auditors' perceptions on political connections, the interviews were also carried out to investigate how such connections may bring costs and benefits to the firms, as well as how they affect corporate governance. Political connections occur in corporate governance and the findings from the interviews show that having very close connections may potentially be the main driver for companies. And almost all interviewees whose companies have politicians on their board agreed that a dominant figure does influence the company's decision making.

#### **5.3.1. Political Connections as External Resources for Companies**

The evidence shows that in the Malaysian setting, the government frequently turns to non-financial channels which are politically connected to add value to companies and obtain information to raise capital and financing, and make listing decisions. This is supported by Du (2011), who documents the importance of political connections for firms to gain access to public debt markets.

This view is shared by an external auditor (EA4)<sup>14</sup>: *Most of the time, for public listed or GLCs you don't choose outside people. They need this to portray to the shareholders and also the other point is that if you make millions, but the auditee is somebody not known by the shareholder, they have doubts. You want your investors to have some level of confidence. The shareholder will question all actions taken by the board, but perceptions and image are among the important things that need to be considered. (EA4)*

The evidence extends prior studies by Chidambaran et al. (2011) and Dey and Liu (2010), which addressed the extent to which professional connections influence board decision making. In this study, evidence shows that having

politically connected individuals or influence may compromise the direction of companies. Thus, having such connections may offer potential benefits, since management and audit committee members may develop business relationships, leading to trust, confidence and a good working rapport (Bruynseels and Cardinaels 2013; Hoitash 2011).

#### **5.3.2 Political Connections Coexist with Good Corporate Governance**

Almost all interviewees mentioned that having someone influential in companies may create a dominant figure himself or herself, which affects the audit process indirectly. Despite having political connections maybe adding value to companies, a few interviewees argued that the connection might potentially affect the auditor and client engagement. As one audit partner (AP4)<sup>15</sup> mentioned:

*In addition, overall it goes back to the leadership at the top for each firm. At the working level respective engagement partner, all of us need to be aware we do not take an engagement basically more than a certain percentage of the firm's revenue, because the reason being the clients may threaten us. We do not want to be in that position. Before we accept an engagement we need to be aware of the level of fee even though the fee is quite handsome. The partner will go and accommodate the initial engagement. On a long-term basis you will meet the same client all over again. If you can see at the recent election the competition is very close, as I can say it is a balanced vote, as half of the party won and half of the voters did not win. (AP4)*

Other than the external auditors, the interview also asked the audit committee members about their views on companies that have political elements in them. One audit committee member (AC1)<sup>16</sup> responded:

*There has to be acceptance from the top. This is a really important function and not just a blessing. I think it needs the sort of enthusiastic support of the people at the top and that includes both the board and management. So, when the top accept it from the very beginning they have to be very responsible to reduce any component of risk which we are*

<sup>14</sup> Interview with External Auditor (EA4), 21<sup>st</sup> March 2017.

<sup>15</sup> Interview with Audit Partner (AP4), 5<sup>th</sup> March 2017.

<sup>16</sup> Interview with Audit Committee member (AC1), 25<sup>th</sup> March 2017.



*talking about as political risk. The internal control must be there, the support from the CEO, the governance is put into place. (ACI)*

The findings explain that good corporate governance practices appear to co-exist with a higher level of political connections in a complementary manner. This also accords with the earlier hypotheses by Shen et al. (2015) that firms are usually willing to strengthen corporate governance to increase their value and that building strong political connections may be one of the considerations to ensure smooth business operations for their companies.

## 5. Conclusion

These interviews provide a rich source of support and new details on the complexity of the relationship between politically connected board or audit committees and auditors. First, the study reveals the views of external auditors and audit committee with regards to political connections. Political connections appear to have a strong influence in Malaysian companies. Second, the evidence from the interviews also revealed that, especially in companies which have politicians on their board, they are involved with a variety of auditor client negotiation processes, difference cultures and mentalities (combining ethics and business) and that the pressure on audit scope and audit process could well come directly from political connections. In addition to that, it is an alarming signal for audit firms as the client's political background may potentially affect the audit process, demand differing audit requirements, and endanger auditor independence, while the findings constitute an indicator for auditors to strategically plan their audit scope before accepting any audit engagements.

The main finding from the interviews shows whether politically connected board or audit committees may potentially affect the audit process. Political connections become competing forces of audit risk, as they are much involved with variety of auditor client negotiation processes, client bargaining power and limited revelation of information due to political implications potentially increasing an auditor's assessment of inherent risk and

control risk. The interviews provide in depth evidence from a qualitative point of view on whether politically connected board or audit committees could affect the audit process and contribute to a higher audit fees. The findings have affirmed the purpose of the interviews to reinforce and confirm findings from the quantitative data analyses. In addition to that, the interviews also provided extra, valuable information that complements and strengthens the findings obtained quantitatively.

Furthermore, the interviews suggest that politically connected individual may have an influence in the corporate sector when the management and shareholders perceive that such connections bring value to the company. There is a climate encouraging this connection and this need to be monitored by functional units within companies, especially the internal audit and audit committee. The findings from the interviews revealed extra information and provided useful insight into the relationship between politically connected companies and the components of corporate governance. Political connections are found not to be riskier if companies have strong components of corporate governance. On the basis of the interview findings, there is evidence that governance effects complement and create value as a result of political connections. The board acknowledges the benefits of better corporate governance and thus the shareholder perceives political connections as tools to stabilise the company's growth and maintain their reputation. This evidence suggests that political connections and good corporate governance can and do co-exist and they tend to be complementary. On the other hand, there appears to be a set of local institutional factors that shape the ownership, cultural and business environment of Malaysia's listed companies through the existence of political connections. The cultural factors at play in Malaysia, through government investment and representation on boards of directors, help to 'keep the company honest' by providing a disinterested voice in corporate deliberations. Thus, it is important to realise that political connections may actually 'raise the tone' of corporate culture in emerging economies such as Malaysia.

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