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Risk management committee, political connection and audit pricing: Evidence from Malaysia

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ABSTRACT

This study investigates the impact of risk governance mechanisms on audit pricing in a relationship-based context. Specifically, this study considers how the formation of a Risk Management Committee (RMC) and its characteristics affect audit pricing and what its moderating effects are on the relationship between political connection and audit pricing. This study uses 2,460 firm-year observations from 2012 to 2017, comprising data from non-financial firms listed on the Main Market of Bursa Malaysia, Malaysia's stock market. A panel regression analysis was adopted in the main analysis, which generated mixed support for the hypotheses. Results showed that auditors charged higher audit fees to politically connected firms. Similarly, politically connected firms that have an RMC tend to pay more audit fees. RMC meeting frequency, size and expertise are associated with lower audit fees. Politically connected firms with an RMC with independent members and more diverse experts tend to pay lower audit fees. The findings from this study can provide guidance to policy makers and practitioners on the composition of the RMC when formulating future risk management legislation.

Contribution/Originality: To the best of the authors' knowledge, this study is among the few studies that examine the linkage between risk management committees and audit pricing among Malaysian politically connected firms. The findings add to the existing works related to risk-based auditing and risk governance.

1. INTRODUCTION

While traditional auditing focuses more on financial statement risks, the International Standard of Auditing No. 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*, suggests a risk-based auditing approach, which requires the auditor to have an understanding of the firm, the industry and the external environment in order to properly assess the risks that the firm faces (International Auditing and Assurance Standards Board (IAASB), 2003). It also provides a basis for audit risk assessment and influences the audit planning and audit pricing decisions (Bell, Landsman, & Shackelford, 2001). The parallel development of risk-based auditing is gaining attention with regard to risk management. After the explosion of Enron, WorldCom and a few other cases, ample risk management regulations and frameworks have been introduced, including the Sarbanes–Oxley

Act of 2002 by the US government and Enterprise Risk Management - Integrated Framework by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) (2004). Corporate governance observers have introduced best practices and guidance that recommends public listed firms focus more on risk management, including the formation of a board-level risk management committee (RMC).

Prior studies have provided evidence based on the agency view that RMCs help to realign agency conflicts and to reduce agency costs (Cohen, Hoitash, Krishnamoorthy, & Wright, 2014; Ellul, 2015; Hines & Peters, 2015; Xie, Davidson, & DaDalt, 2003). In addition, some researchers have acknowledged the strategic role of RMCs to integrate risk oversight with business objectives and strategic planning from the resource dependence angle (Al-Hadi, Hasan, & Habib, 2016; Cohen, Krishnamoorthy, & Wright, 2017; Desender & Lafuente, 2011; Tao & Hutchinson, 2013). However, most of these studies were conducted in a developed market context. One logical question is whether previous findings are also relevant in an emerging market where the formation of RMCs is voluntary and corporate political connection is pervasive.

The primary objective of this study is to explore the impact of a formalized risk governance mechanism on external audit pricing, particularly in Malaysian firms with political backgrounds and linkages. Specifically, this study investigates whether the voluntary formation of an RMC and its composition have any impact on audit pricing. It also examines whether auditors are likely to reduce their perceived audit risk for politically connected firms that have an RMC.

Using a sample of 2,460 firm-year observations from 2012 to 2017, we discovered a positive association between political connections and audit fees. The presence of risk management proxied by the formation of an RMC is positively associated with audit fees. Although the formation of an RMC is negatively associated with audit fees in politically connected firms, the association is insignificant. When RMC characteristics are taken into consideration, it was discovered that meeting frequency, size and expertise reduce audit fees. Moreover, politically connected firms with an RMC that have more independent members and more diverse experts tend to pay lower audit fees.

This study offers a few contributions. First, the study extends the risk-based auditing literature by providing evidence of how the formalism of risk governance mechanisms affects audit pricing. It is increasingly important for auditors to leverage effective risk governance mechanisms as part of their audit risk assessment to increase the value of the audit (Knechel, 2007). Second, prior research mostly observed the effect of risk management on firm outcomes in financial institutions (Battaglia & Gallo, 2015; Hines & Peters, 2015; Nahar, Jubb, & Azim, 2016). This paper provides an inimitable opportunity to examine the role of RMCs and how they relate to other actors in the corporate governance mosaic (the auditor) in non-financial firms. Finally, the findings highlight the informative nature of voluntary actions of firms to form an RMC when there is no regulatory mandate. Understanding the prospective impact of voluntary risk management practices in Malaysia offers an insight into the development of risk management in other countries with similar institutional settings.

The remainder of this paper is organized into four sections. Section 2 reviews related literature, Section 3 explains the hypothesis development, Section 4 describes the sample selection and research design, Section 5 presents the results, and the final section concludes the paper.

2. LITERATURE REVIEW

2.1. Risk Management Committee

The Malaysian Code on Corporate Governance (MCCG) (2021) is the main source of corporate governance guidelines for public listed firms. It first introduced risk management in 2000, which requires the board of public listed firms to understand the principal risks of all aspects of the business. The revised MCCG in 2012 recommends that public listed firms establish a separate RMC to supervise the risk management framework and its implementation. Later, the "Statement on Risk Management and Internal Control: Guidelines for Directors of Listed Issuers" was issued by Bursa Malaysia. The Statement serves as a guideline for directors of public listed firms in

making risk management and internal control disclosures in annual reports in accordance with Paragraph 15.26(b) of the Listing Requirements (Bursa Malaysia, 2012). Malaysian regulators continuously revise the guidelines and best practices following changes in the regulatory environment, attributable to the global evolution of risk management. However, Malaysia's regulators have not issued any uniform risk management policy that can guide firms to implement a structured approach to risk management in their business process. To date, even though the formation of an RMC is strongly recommended, it is still not mandatory in Malaysia.

Previous studies exploring the significance of RMCs mainly focus on developed markets (Bailey, Collins, & Abbott, 2018; Desender & Lafuente, 2011; Knechel & Willekens, 2006) and financial firms (Hines & Peters, 2015). For instance, Aebi, Sabato, and Schmid (2012) found that RMCs positively assist boards of directors in monitoring business risks. Battaglia and Gallo (2015) showed that RMC size varied positively with firm performance indicators for a sample of Chinese and Indian listed banks. Also, Al-Hadi et al. (2016) concluded that RMCs are likely to assert more efforts to improve the disclosure of risk-related information, which eventually reduces information asymmetry between management and other stakeholders. Hines and Peters (2015) found that the existence of RMCs is positively linked to audit fees for U.S. listed banks. Still, there is limited knowledge about the link between RMCs and the auditing process, especially in a relationship-based economy such as Malaysia. This is crucial as RMCs, being unique risk governance mechanisms, can assist the auditor's risk assessment and affect the amount of audit fees in politically connected firms.

2.2. Political Connection

In Malaysia, political connections are relatively widespread in the corporate sectors since pre-independence to the present day. Politically connected firms have close relationships with business leaders and political actors, for example, senior government officials, party leaders, or elected legislators (Fisman, 2001). It is widely known that politically connected firms receive more government favors, including lucrative government contracts, preferential access to financing, granting of licenses, tariff protection, lower taxation and greater likelihood of government bailouts during a crisis (Agrawal & Knoeber, 2001; Goldman, Rocholl, & So, 2009; Johnson & Mitton, 2003; Khwaja & Mian, 2005; Yeh, Shu, & Chiu, 2013). These political benefits improve the performance of politically connected firms, thus bringing wealth to business owners and shareholders. In return, they give their votes and loyalties to the government.

However, past empirical evidence advocates that politically connected firms are perceived as high-risk firms by the market. For instance, Chaney, Faccio, and Parsley (2011) posited that connected firms have more incentive to produced opaque financial information due to lower chances of receiving a penalty from the regulators. Yu and Yu (2011) found that cases of fraud in politically connected firms are less likely to be detected. Additionally, politically connected firms are more likely to carry out risky investments, which lead to higher earnings volatility (Boubakri, Mansi, & Saffar, 2013). Borisova, Brockman, Salas, and Zagorchev (2012) discovered that connected firms from the European Union have poor corporate governance due to increased agency problems. Collectively, auditors perceive firms with political ties to have higher levels of risk, therefore they tend to charge higher audit fees (Amin, Kim, Yang, & Ye, 2021; Aswadi, Mat Zain, & James, 2011; Gul, 2006).

2.3. Audit Pricing

According to the risk-based audit approach adopted by the International Standard of Auditing (ISA), audit fees increase with a rise in audit risk (Bell et al., 2001). Auditors respond to increased audit risk by appointing additional experienced professional staff to the engagement or devoting more time for thorough checking, leading to greater audit fees. Bell et al. (2001) found evidence that showed audit effort as well as audit fees are increasing in the assessment of inherent risk by the auditors. Jiang and Son (2015) indicated that auditors adjust risk premiums as well as audit efforts in response to the seriousness of internal control issues in firms, which is partly consistent with Hogan

and Wilkins (2008), who stated that audit fees increase because of auditors increasing their testing in the presence of increased control risk.

Few researchers have generally integrated the developing concept of risk management within auditing studies. Knechel (2007) argued that firms equipped with established risk management processes have lower risk and can therefore be audited with fewer resources. Desender and Lafuente (2011) suggested that other than creating conditions for enhanced internal supervision, the presence of risk management practices also facilitate the work of auditors. Knechel and Willekens (2006) reported that disclosures regarding risk management affect audit fees positively. All of these observations, however, were valid under the US and European settings. Prior studies on auditing did not contain much information on how risk management practices affect audit pricing in developing markets.

3. HYPOTHESIS DEVELOPMENT

3.1. RMCs and Audit Fees

Consistent with the risk-based audit approach, Tsui, Jaggi, and Gul (2001) and Cohen, Krishnamoorthy, and Wright (2007) demonstrated that when firms have stronger governance, auditors tend to reduce their audit efforts. Desender and Lafuente (2011) provided empirical evidence that risk management and external auditing are substitutes. Their finding is particularly relevant as it signals that the presence of risk management improves a firm's internal monitoring, and correspondingly facilitates auditors' work. Auditor's reliance on risk management functions should help to reduce the audit hours needed and thus reduce the audit fees (Knechel & Willekens, 2006). Also, the formalized risk management structure, i.e., the RMC, will identify and monitor emerging risks that might affect the firm's strategic objectives (Hines & Peters, 2015; Tao & Hutchinson, 2013). This allows auditors to have a higher comfort level in audit risk assessments. Based on the above arguments, the first hypothesis is as follows:

H1: The presence of a risk management committee is associated with a lower audit fee.

3.2. RMC Characteristics and Audit Fees

To investigate the association between RMC composition and audit fees, this study focusses on four characteristics: independence, meeting frequency, size, and expertise.

3.2.1. RMC Independence

The trend for regulators to require firms to include independent directors on the RMC has become pronounced. For example, the Australian Securities Exchange (ASX) Corporate Governance Council (2014) suggests that the independent risk committee should be led by an independent chairman. The Malaysian Code on Corporate Governance (2021) proposed a similar practice in which there should be a majority of independent directors on the RMC for public listed firms. Sharma and Kuang (2014) provide evidence that independent directors act as monitors of management, consistent with observations by Xie et al. (2003) and Chen, Kilgore, and Radich (2009). In addition, independent directors have access to critical resources and information that are not offered by internal directors (Dalton, Daily, Johnson, & Ellstrand, 1999). Using a sample of US banks, Hines and Peters (2015) discovered that independent risk committees tend to pay lower audit fees. Based on the above underlying argument, the following hypothesis is proposed:

H2a. A risk management committee with a higher proportion of independent directors is associated with a lower audit fee.

3.2.2. RMC Meeting Frequency

Several studies have found that meeting frequency varies negatively with earnings management (Xie et al., 2003), fraud (Abbott, Park, & Parker, 2000), and financial reporting misstatements (Abbott, Parker, & Peters, 2004). This evidence suggests that an active board level committee demonstrates a higher level of diligence in performing its

supervisory role (Menon & Williams, 1994). Empirically, Aebi et al. (2012) found that an active RMC contributed to the performance of banks during the global financial crisis of 2007/2008. Furthermore, Andrew Ellul and Yerramilli (2013) documented a lower enterprise-wide risk and more favorable stock returns throughout the same crisis period when US listed banks have a diligent RMC in place. Based on the arguments above, the researchers hypothesize that:

H2b. A risk management committee that meets more frequently is associated with a lower audit fee.

3.2.3. RMC Size

Kalbers and Fogarty (1993) suggested that the size of a board level committee is likely to signal its status and power within an organization and influence the demand of audit quality. Ghafran and O'Sullivan (2017) found that small audit committees are associated with higher audit fees, and auditors may view smaller audit committees as requiring more effort. In a similar vein, Tao and Hutchinson (2013) suggested that the size of the RMC should be large enough to monitor excessive risk, especially in firms where agency costs are high. Although small boards are more united, large boards improve firm performance since they possess more resources, experience, advice, information and human capital (Dalton et al., 1999). Based on the arguments above, the following hypothesis is developed:

H2c. A risk management committee with more members is associated with a lower audit fee.

3.2.4. RMC Expertise

Hillman and Dalziel (2003) argued that board committees with relevant expertise may be better at both monitoring management and providing resources. Also, Conger, Finegold, and Lawler (1998) contended that the combined knowledge and experience of the committee members is needed because today's business environments are so complex and it is nearly impossible for individual to understand all the issues. Similarly, the importance of diverse knowledge and skills has been highlighted by Brown, Steen, and Foreman (2009). Andrew Ellul and Yerramilli (2013) provided further support of this proposition by showing that RMC members with industry experience increased its effectiveness. In Singapore, the Risk Governance Guidance for listed firms specifically stresses the importance of diverse backgrounds and skills for RMC members (Organization for Economic Co-Operation and Development (OECD), 2014). Drawing from the preceding discussion, the following hypothesis is developed:

H2d. Risk management committee expertise is associated with a lower audit fee.

3.3. Political Connection, Risk Management and Audit Fee

Hines and Peters (2015) argued that effective risk monitoring reduces audit risk. It is logical to posit that the perceived audit risk for politically connected firms will be lower with the adoption of risk governance. The establishment of an RMC is an important signal to shareholders and other stakeholders, including auditors, that risk which is normally associated with politically connected firms, such as misreporting, earnings management, business failure and excessive leverage, will receive attention at the board level. Moreover, Tao and Hutchinson (2013) suggested that high-risk firms need a committee that is competent in managing and monitoring risk, as they will bring in more external resources to improve firms' risk management effectiveness. This is especially true for politically connected firms, which are commonly being viewed as high-risk compared to non-connected firms (Amin et al., 2021). Hence, we expect that if politically connected firms have a strong risk management framework that effectively identifies and mitigates risks, auditors may be able to rely on that framework, reducing the amount of time and effort required for the audit. This gives rise to the following hypothesis:

H3. Firms with a risk management committee pay lower audit fees, and this association is expected to be stronger for politically connected firms.

4. METHODOLOGY

4.1. Sample

The top 500 firms, ranked by their market capitalization, are chosen from Bursa Malaysia's Main Market. The initial sample was narrowed down to 410 firms after excluding financial firms, firms that do not have annual reports and firms with unavailable data. This leaves unbalanced panel data of 2,460 firm-year observations from 2012–2017. Following most of the political economy literature (e.g., (Bliss & Gul, 2012; Faccio, 2006; Fraser, Zhang, & Derashid, 2006; Gul, 2006)), a firm is considered politically connected if at least one of its largest shareholders or one of its top officers is: (1) a member of parliament, (2) a minister or head of state, or (3) closely related to a politician or political party. In this study, government-linked companies were also included (Fung, Gul, & Radhakrishnan, 2015).

4.2. Research Design and Regression Model

A pooled ordinary least squares (OLS) regression estimated with clustered robust standard errors was used as a baseline model, consistent with extant studies (for example, (Hines & Peters, 2015; Nahar et al., 2016; Tao & Hutchinson, 2013)).

The following model has been developed to investigate the association between political connections, the presence of an RMC, and audit fees.

$$LNAF_{i,t} = \beta_0 + \beta_1 PCON_{i,t} + \beta_2 RMC_{i,t} + \beta_3 PCON * RMC_{i,t} + \beta_4 LNSIZE_{i,t} + \beta_5 LNSUB_{i,t} + \beta_6 RECV_{i,t} + \beta_7 INV_{i,t} + \beta_8 LEV_{i,t} + \beta_9 BIG4_{i,t} + \beta_{10} ROA_{i,t} + (YEAR) + (IND) + \varepsilon_{i,t} \quad (1)$$

The dependent variable, *LNAF*, is the natural logarithm of audit fees. Both experimental variables, *PCON* and *RMC*, are categorical. We adopt several control variables that are expected to influence audit fees based on prior studies. Firm size (SIZE) and number of subsidiaries (LNSUB) are used to control for firm complexity (Al-Hadi et al., 2016; Ghafran & O'Sullivan, 2017; Tao & Hutchinson, 2013). Audit risk is proxied by inventory (INV) (Carcello, Hermanson, Neal, & Riley Jr, 2002), accounts receivable (RECV) (Redmayne, Bradbury, & Cahan, 2011), and leverage (LEV) (Amin et al., 2021; Hines & Peters, 2015). To control for difference in audit quality, type of auditor (BIG4) is used (Carcello et al., 2002), and return on assets (ROA) is used as the proxy for firm performance (Aswadi et al., 2011). Table 1 presents the definition of all variables used in the analysis.

Table 1. Variable definitions.

Variable	Measurement
Audit fees (LNAF)	The natural logarithm of audit fees
Political connection (PCON)	1 for a politically connected firm, 0 otherwise
Existence of an RMC (RMC)	1 for the existence of an RMC, 0 otherwise
RMC independence (RMCIND)	The percentage of independent RMC members
RMC meetings (RMCMEET)	The number of meetings held by the RMC during the year
RMC size (RMCSIZE)	1 if the size of the RMC is above average across all samples, 0 otherwise
RMC expertise (RMCEXP)	1 if RMC members possess more than one area of expertise, either finance, industry or legal
Firm size (LNSIZE)	The natural logarithm of total assets
Subsidiary (LNSUB)	The natural logarithm of the number of subsidiaries
Accounts receivable (RECV)	The ratio of accounts receivable to total assets
Inventory (INV)	The ratio of inventory to total assets
Leverage (LEV)	The ratio of total debt to total assets
Auditor (BIG4)	1 for a Big 4 auditor, 0 otherwise
Return on assets (ROA)	Earnings before interest, tax and extraordinary items divided by total assets

This study further investigates the association between political connections, RMC characteristics and audit fees by estimating the following equation:

$$LNAF_{i,t} = \beta_0 + \beta_1 PCON_{i,t} + \beta_2 RMCIND_{i,t} + \beta_3 RMCMEET_{i,t} + \beta_4 RMCSIZE_{i,t} + \beta_5 RMCEXP_{i,t} + \beta_6 PCON * RMCIND_{i,t} + \beta_7 PCON * RMCMEET_{i,t} + \beta_8 PCON * RMCSIZE_{i,t} + \beta_9 PCON * RMCEXP_{i,t} +$$

$$\beta_{10}LNSIZE_{i,t} + \beta_{11}LNSUB_{i,t} + \beta_{12}RECV_{i,t} + \beta_{13}\mathrm{INV}_{i,t} + \beta_{14}\mathrm{LEV}_{i,t} + \beta_{15}\mathrm{ROA}_{i,t} + (\mathrm{YEAR}) + (\mathrm{IND}) + \varepsilon_{i,t} \quad (2)$$

There are four experimental variables used in Equation 2 to proxy for RMC characteristics. RMC independence (RMCIND) and RMC meetings (RMCMEET) are continuous variables, while RMC size (RMCSIZE) and RMC expertise (RMCEXP) are categorical. We use the same control variables as Equation 1.

5. EMPIRICAL ANALYSIS

5.1. Descriptive Statistics

Table 2 presents the descriptive statistics for the dependent, experimental and control variables. The average audit fee (AF) is RM0.44 million and the average natural logarithm of audit fees (LNAF) recorded a mean of 12.41. Panel D shows that 427 observations (17.4%) are politically connected firms, while the remaining 2,033 observations (82.6%) are non-politically connected firms. There are 963 firm-year observations (39.1%) with an established board-level RMC throughout the six-year period from 2012 to 2017. With regard to RMC characteristics, the mean percentage of independent directors is 29%. On average, RMCs meet 2.01 times a year, while some do not hold any meetings and some meet regularly (up to 10 times a year). Approximately 35% and 27% of the sample have a large RMC and possess more than one area of expertise either in finance, industry or legal, respectively (refer to Panel D of Table 2).

Table 2. Descriptive statistics for all variables.

Variables	Mean	Median	Min.	Max.	SD
Panel A: Dependent variable					
AF (RM million)	0.44	0.22	0.02	10	0.78
LNAF	12.41	12.31	10.20	14.50	0.87
Panel B: Experimental variables					
RMCIND	0.29	0	0	1	0.38
RMCMEET	2.01	0	0	10	2.71
Panel C: Control variables					
SIZE (RM million)	3.476	739	3.8	287.894	11.688
LNSIZE	20.59	20.42	17	24	1.38
SUB	20.25	15	0	88	18.28
LNSUB	2.65	2.71	0	4.60	1.09
RECV	0.16	0.14	0	0.46	0.10
INV	0.10	0.07	0	0.37	0.10
LEV	0.17	0.145	0	0.65	0.15
ROA	5.65	4.78	-18.58	29.45	7.29
Panel D: Dichotomous variables		Yes	%	No	%
PCON		427	17.4	2033	82.6
RMC		963	39.1	1497	60.9
RMCSIZE		860	34.9	1600	65
RMCEXP		673	27.3	1787	72.6
BIG4		1431	58.2	1029	41.8

Note: Observations with a zero for LNSUB are re-coded to a small positive (0.0001) to enable a logarithm transformation.

Table 3. Correlations matrix.

N = 2460	LNAF	PCON	RMC	RMCIND	RMCMEET	RMCSIZE	RMCEXP	LNSIZE	LNSUB	RECV	INV	LEV	BIG4	ROA
LNAF	1													
PCON	0.395***	1												
RMC	0.191***	0.178***	1											
RMCIND	0.156***	0.146***	0.963***	1										
RMCMEET	0.047***	0.121***	0.925***	0.903***	1									
RMCSIZE	0.057**	0.119***	0.914***	0.882***	0.890***	1								
RMCEXP	-0.050***	0.087***	0.765***	0.753***	0.789***	0.827***	1							
LNSIZE	0.762***	0.397***	0.175***	0.144***	0.055***	0.066***	-0.020	1						
LNSUB	0.662***	0.235***	0.121***	0.099***	0.017	0.033**	-0.033	0.542***	1					
RECV	-0.140***	-0.107***	-0.005	0.001	0.020	0.023	0.043**	-0.334***	-0.171***	1				
INV	-0.156***	-0.173***	-0.101***	-0.089***	-0.086***	-0.069***	-0.076***	-0.269***	-0.227***	0.226***	1			
LEV	0.286***	0.085***	0.056***	0.046***	0.007	0.016	-0.027	0.324***	0.258***	-0.032	0.045**	1		
BIG4	0.299***	0.199***	0.136***	0.111***	0.081***	0.114***	0.056***	0.336***	0.127***	-0.104***	-0.110***	0.088***	1	
ROA	-0.141***	-0.012	-0.015	-0.012	-0.002	0.015	0.032	-0.111***	-0.240***	0.110***	0.072***	-0.278***	0.025	1

Note: The superscripts *** and ** denote the 1% and 5% levels of significance, respectively.

The mean natural logarithm of total assets (LNSIZE) is 20.59 (RM3,476 million) and ranges from 17 (RM3.8 million) to 24 (RM287,894 million). The average number of subsidiaries (SUB) is 20.25. The sample firms have an average receivables ratio (RECV) of 0.16 and an inventory ratio of (INV) of 0.10. The data presents a mean leverage ratio of 0.17. Return on assets (ROA) has a mean of 5.65 with minimum and maximum values of -18.58 and 29.45, respectively. As shown in Panel D, 58.2% of the sample firms engage Big Four firms (BIG4) as their auditor, while other small and medium-sized audit firms comprise 42.8% of the Malaysian audit market.

Table 3 presents the Pearson correlation among the variables in the study. The correlation results generally show that audit fees (LNAF) are significantly and positively correlated with political connection (PCON), the existence of an RMC (RMC), RMC independence (RMCIND), RMC meeting frequency (RMCMEET), RMC size (RMCSIZE), firm size (LNSIZE), number of subsidiaries (LNSUB), leverage (LEV) and Big Four auditors (BIG4). Conversely, LNAF is significantly and negatively associated with RMC experts (RMCEXP), accounts receivables (RECV), inventory (INV) and return on assets (ROA).

It is worth noting that the correlations between RMC and the RMC characteristics of RMCIND, RMCMEET and RMCSIZE are higher than 0.90. One of the reasons is that the variables used in the analysis share a similar tendency (Gujarati, 2003). In other words, RMC, RMCIND, RMCMEET and RMCSIZE may all exist (increase) or cease (decrease) over time at more or less the same rate, leading to collinearity among these variables. However, a simple correlation will not provide an infallible guide to the presence of multicollinearity (Gujarati, 2003). Therefore, this study uses the variance inflation factor (VIF) as an indicator of multicollinearity, whereby the variable is said to be highly collinear if the VIF value exceeds 10 (Tabachnick & Fidell, 2013). The unreported VIF test results indicate that for both models, all variables have VIF values of less than 10, suggesting that there is no serious multicollinearity.

5.2. Regression Results

Table 4 presents the panel regression results for the 2,460 firm-year observations from 2012 to 2017. The models have explanatory power with an adjusted R-squared of approximately 71% across all models and significance at the 1% level. Models 1 and 2 found the natural logarithm of audit fees (LNAF) to be positive and significant in relation to political connections (PCON), consistent with Amin et al. (2021). RMC as a proxy of risk management reports a positive but insignificant association with audit fees (0.024, $p > 0.01$; 0.046, $p > 0.01$); therefore, Hypothesis 1 is not supported. This is justifiable by using a complementary view of auditing whereby the presence of a corporate governance mechanism might lead to an increase in the demand for external auditing services (Collier & Gregory, 1996; Goodwin-Stewart & Kent, 2006). Hines and Peters (2015) reported a positive association between voluntary RMCs and audit fees, which further supports the complementary view, while our insignificant results may reflect the countervailing relations between audit fees and governance as postulated by Griffin, Lont, and Sun (2008). Desender and Lafuente (2011) reported that the presence of a chief risk officer as a proxy for risk management does not influence audit fees. The interaction between political connections and the presence of an RMC (PCON*RMC) produces a negative moderating effect on audit fees, albeit insignificant (-0.118, $p > 0.01$). This result supports the viewpoint that auditors perceive an RMC as ineffective as a risk management mechanism in politically connected firms (Collier & Gregory, 1996). RMCs might have been formed for symbolic reasons or to merely tick the corporate governance box recommended by the regulators (Aswadi et al., 2011; Redmayne et al., 2011).

Model 3 reports the corresponding analysis for the base model of RMC characteristics. RMC independence (RMCIND) is positively associated with audit fees (LNAF) (0.406, $p < 0.001$). Advocates for the demand effect argue that independent directors are not as familiar with business operations as insiders. Therefore, they may demand a greater amount of external auditing with the intention of protecting their reputational capital, leading to higher audit fees (Carcello et al., 2002; Goodwin-Stewart & Kent, 2006). The regression results show a negative association between RMC meeting frequency (RMCMEET) and LNAF (-0.021, $p < 0.10$). This suggests that an active RMC is effective in fulfilling their risk monitoring role by providing timely input and enterprise-wide oversight on critical

risk issues (Tao & Hutchinson, 2013). However, no significant association exists between RMC size (RMCSIZE) and LNAF. A possible justification is that when the RMC size is closer to the size of a full board, auditors may view the large RMC as unnecessary or as window dressing only. Also, Model 3 shows that RMC expertise (RMCEXP) is associated with lower audit fees (-0.208, $p < 0.01$). Consistent with the resource-based view, the knowledge and experience of board members play a critical role in formulating strategic objectives, making important decisions and evaluating strategy implementation in the firm (Carpenter & Westphal, 2001). They are also expected to reduce control risk, which eventually leads to lower business risk and lower audit fees.

In Model 4, politically connected firms tend to pay lower audit fees with more independent directors on the RMC (-0.511, $p < 0.05$). An independent RMC does not only improve the quality of monitoring in politically connected firms, but also brings the firm's focus back to managing critical risk inherent in the corporate strategy. This lessens the audit risk, which will subsequently be taken into consideration when the auditors perform a risk assessment. Model 4 also shows that diverse expertise of an RMC is associated with lower audit fees in politically connected firms (-0.246, $p < 0.05$). This finding corresponds to the supply-side viewpoint inferred from auditing research (DeFond & Zhang, 2014). RMC experts help to strengthen the governance structure and reduce control risk and inherent risk in politically connected firms since such firms commonly have a governance deficiency. Consequently, auditors will perform fewer audit procedures, thus lowering the audit fees (Tsui et al., 2001; Xie et al., 2003). Consistent with the resource dependence view, a board with diverse experience can exercise more effective monitoring (Carpenter & Westphal, 2001; Hillman & Dalziel, 2003).

Table 4. OLS robust regression results for audit fees (2012–2017).

Dependent variable = LNAF	**(1)**	**(2)**	**(3)**	**(4)**
PCON	0.233***	0.296***	0.246***	0.328***
RMC	0.024	0.046		
PCON*RMC		-0.118		
RMCIND			0.406***	0.597***
PCON* RMCIND				-0.511**
RMCMEET			-0.021*	-0.029**
PCON* RMCMEET				0.028
RMCSIZE			-0.062	-0.196*
PCON* RMCSIZE				0.303*
RMCEXP			-0.208***	-0.145***
PCON* RMCEXP				-0.246**
LNSIZE	0.350***	0.350***	0.338***	0.333***
LNSUB	0.290***	0.289***	0.283***	0.280***
RECV	0.798***	0.798***	0.801***	0.792***
INV	0.667***	0.671***	0.597***	0.605***
LEV	-0.031	-0.029	-0.034	-0.027
BIG4	0.117***	0.110***	0.122***	0.127***
ROA	-0.001	-0.001	-0.001	-0.001
Constant	4.047***	4.042***	4.324	4.415
N	2460	2460	2460	2460
Adjusted R^2	0.704	0.704	0.713	0.716
F-statistic	116.71	108.32	104.23	92.22

Notes: The superscripts ***, ** and * denote the 1%, 5% and 10% levels of significance, respectively.

The coefficients of most of the control variables are in line with the predicted sign, except leverage (LEV). Firm size (LNSIZE) is positively and significantly related to audit fees, comparable with previous studies that have discovered firm size to be a highly important predictor of audit fees (e.g., (Carcello et al., 2002; Knechel & Willekens, 2006)). Audit complexity, proxied by the number of subsidiaries (LNSUB), is positively associated with audit fees. Also, accounts receivable (RECV) and inventory (INV), which measure inherent risk, are positively associated with

audit fees. Hay, Knechel, and Ling (2008) also noted a similar relationship. The regression results show that leverage is negatively associated with audit fees. However, the coefficients are not statistically significant, suggesting that leverage might not be one of the main cost drivers of audit fees in a relationship-based economy setting. Concerning the type of external auditor, the Big Four auditors (BIG4) exert positive and significant effects on audit fees. This is consistent with previous findings documented by Desender and Lafuente (2011) and Hines and Peters (2015). Finally, for the firm performance control variables, a higher return on assets (ROA) is associated with lower audit fees, although the coefficients are insignificant.

5.3. Generalized Method of Moments

To address the potential issue of endogeneity, the dynamic panel generalized method of moments (GMM) approach was adopted. The GMM fits when the number of observations is large and the time period is small (Roodman, 2009). Hence, the GMM is well suited to this study where there are 2,460 firm-year observations across a six-year period. Additionally, there are three issues that the traditional audit fee models may have omitted: endogeneity, unobserved heterogeneity and the dynamic nature of audit fees (Kacer, Peel, Peel, & Wilson, 2018). The GMM model is able to accommodate all of these issues, which further supports its use for this study.

Following Kacer et al. (2018), this study uses the two-step system GMM technique to explore the dynamic association between political connection, the existence of an RMC (RMC characteristics), and audit fees. To apply the system GMM model, Equations 1 and 2 can be re-written as follows:

$$LNAF_{i,t} = \beta_0 + \beta_1 LagLNAF_{i,t} + \beta_2 PCON_{i,t} + \beta_3 RMC_{i,t} + \beta_4 PCON * RMC_{i,t} + \beta_5 CONTROLS_{i,t} + \varepsilon_{i,t} \quad (3)$$

$$LNAF_{i,t} = \beta_0 + \beta_1 LagLNAF_{i,t} + \beta_2 PCON_{i,t} + \beta_3 RMCIND_{i,t} + \beta_4 RMCMEET_{i,t} + \beta_5 RMCSIZE_{i,t} + \beta_6 RMCEXP_{i,t} + \beta_7 PCON * RMCIND_{i,t} + \beta_8 PCON * RMCMEET_{i,t} + \beta_9 PCON * RMCSIZE_{i,t} + \beta_{10} PCON * RMCEXP_{i,t} + \beta_{11} CONTROLS_{i,t} + \varepsilon_{i,t} \quad (4)$$

Where LagLNAF is the lagged value of the natural logarithm of audit fees and $\varepsilon_{i,t}$ is the error term.

Table 5 presents the results for the audit fees model using the system GMM estimator. The association between politically connected firms, the existence of an RMC, and audit fees is explored using Equation 3, whereby Model 1 is the baseline model and Model 2 includes the interaction term. The results of both diagnostic tests are satisfactory. The Wald test is statistically significant at the 1% level for both models, implying that the models fitted the data well. The Arellano–Bond AR(2) test and the Sargan test are statistically insignificant, inferring that both models are free from autocorrelation and endogeneity problems.

After taking into consideration the endogeneity of audit fees, this study continues to find evidence that a risk governance mechanism is less effective in politically connected firms. To a certain extent, auditors view an RMC as deficient in the monitoring of power. Similarly, Redmayne et al. (2011) found that the existence of an audit committee does not reduce the audit risk in public sector firms.

The coefficients in Models 1 and 2 show signs and significance levels that are same as their counterparts presented in Table 4, except for LEV and ROA. Importantly, the LagLNAF coefficients are significant and positive in both models, signifying the dynamic nature of audit fees (Kacer et al., 2018). Interestingly, the findings showed that the coefficients for LEV and ROA are positive, unlike the OLS findings reported in Table 4. The positive but insignificant association between leverage and audit fees is similar to Goodwin-Stewart and Kent (2006) and Redmayne et al. (2011). Both studies used the level of indebtedness as a proxy for financial risk in their audit fees models. However, they did not provide any clarification on the insignificant results. It appears from this model that ROA is not significantly associated with audit fees. This finding is consistent with prior auditing studies (e.g., (Ghafran & O'Sullivan, 2017; Goodwin-Stewart & Kent, 2006)) that suggest that a firm's profitability has little effect on audit fees.

Table 5. Results of the system GMM.

Dependent variable = LNAF	(1)	(2)	(3)	(4)
LagLNAF	0.237***	0.245***	0.242***	0.260***
PCON	0.194***	0.252***	0.204***	0.278***
RMC	0.013	0.029		
PCON*RMC		-0.106		
RMCIND			0.242***	0.319***
PCON* RMCIND				-0.288**
RMCMEET			-0.013**	-0.018***
PCON* RMCMEET				0.018
RMCSIZE			-0.051	-0.085
PCON* RMCSIZE				0.066
RMCEXP			-0.122***	-0.097***
PCON* RMCEXP				-0.105
LNSIZE	0.260***	0.258***	0.249***	0.242***
LNSUB	0.198***	0.195***	0.191***	0.185***
RECV	0.464***	0.461***	0.463***	0.442***
INV	0.464***	0.465***	0.389***	0.389***
LEV	0.083	0.081	0.090	0.092
BIG4	0.113***	0.114***	0.117***	0.117***
ROA	6.881e-05	3.044e-06	0.001	0.001
Constant	3.307***	3.250***	3.516	3.445
N	2,050	2,050	2,050	2,050
Wald test	2,388***	2,409***	2,546***	2,859***
Arellano–Bond test AR(2)	0.61	0.58	0.27	0.28
Sargan test	15.93	15.78	18.91	18.87

Note: The superscripts ***, ** and * denote the 1%, 5% and 10% levels of significance, respectively.

Models 3 and 4 revisit the association between political connection, RMC characteristics and audit fees using Equation 4. It confirms that the models fitted the data well, as the results of the Wald test illustrated. The Arellano–Bond AR(2) tests for autocorrelation also indicated that both models are free from the second order of autocorrelation. In addition, the statistically insignificant Sargan test results showed that the instruments used are appropriate. Overall, the results are comparable to the OLS results presented in Table 4. All explanatory variables are statistically significant at the 10% level or better, except for RMCSIZE, which is similar to the OLS findings. Again, the coefficients for LagLNAF are positive and significant in both models.

Turning to Model 4 with multiple interaction terms, the results are consistent with the main analysis, particularly regarding the impact of RMC independence, meeting frequency and diverse expertise on audit fees. All these explanatory variables are statistically significant at the 1% level. Nevertheless, the size of RMC seems to have no impact on audit fees under the system GMM, as the variable remained statistically insignificant. Three out of the four interaction terms, namely (PCON* RMCMEET), (PCON* RMCSIZE), (PCON* RMCEXP) are also insignificant.

6. CONCLUSION

This paper explores the impact of risk management committees (RMCs) on external audit fees in a relationship-based economy setting. We posit that strong risk management affects the audit risk assessment, which is expected to be reflected in lower audit fees. The regression results showed that RMC characteristics, including meeting frequency, size and diverse expertise, are significantly and negatively associated with audit fees. Furthermore, the negative association between independence, diverse expertise of the RMC, and audit fees are even stronger for politically connected firms. Our results are robust in the additional analyses and the findings remained similar after taking the potential endogeneity problem into account.

The research findings have theoretical and practical implications. First, the study contributes to risk-based auditing literature with supplementing evidence on how the formalization of risk management functions could affect

the audit process. The findings suggest that the structural design of an RMC is more important than its symbolic appearance. Second, the study extends the emerging research on risk management by examining the role of RMCs and how they relate to other corporate governance actors (the auditor) in non-financial firms. Third, the results may encourage the audit profession to restructure some of the formal audit procedures adopted in conventional auditing and to redefine their auditing services to achieve optimal efficiency. Finally, the findings from this study provide input for legislators and policy makers regarding the importance of the structural design of risk management.

This study has limitations that may provide opportunities for future research. First, the data used in this study is specific to the unique institutional setting of Malaysia, impairing the generalizability of the results. Second, since there are no mandatory rules for risk management reporting in Malaysia, the results may be limited if the annual reports do not reflect the true state of risk management practices. Third, the variables used in this study might not be sufficient to explain the association between risk management and auditing. Finally, the academic research related to risk management is emerging and theories concerning risk management are not fully developed in the literature. Hence, the results of this study cannot be taken as unanimously true for all RMCs in all jurisdictions.

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