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The Impact of Corporate Governance Mechanisms on the Audit Fees of Islamic Banks: Evidence from Malaysia

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Abstract

This study examines the influence of corporate governance (CG) structures on audit processes, specifically regarding audit fee pricing within Malaysian Islamic banking (IB) institutions. This research employs panel data from 16 Islamic banks in Malaysia covering the period from 2011 to 2017. Fixed effects specifications are used to estimate the model of regression. The results show a significant negative relationship between audit fees and the independence of audit committees (AC) and the expertise of Shariah committees (SC). The majority of CG variables, however, do not exhibit any substantial relationships with audit fees. The results suggest that a lower-intensity audit is demanded by the agents of internal governance in a highly-regulated industry, possibly due to regulatory supervision and the monitoring of audits overlap. This is the first study on audit fees using IB as the study sample which incorporate and examine SC as one of the unique CG mechanisms that have not been explored in audit fee literature. This paper provides support for the recommendations of the MCCG 2017 and 2021, which involved the step-up practice in relation to the need to establish AC composed only of independent directors. By improving the monitoring function and perhaps lowering the control risk, this AC composition will help organizations receive lower audit fees from their external auditors.

Keywords: *Audit Fees, Corporate Governance (CG), Islamic Banks (IB), Audit Committee (AC), Directors.*

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INTRODUCTION

Some problems with the financial reporting process may have their origins in the deficiencies of the Corporate Governance (CG) system (Shakhatreh & Alsmadi, 2021). Therefore, Bank Negara Malaysia (BNM) has issued the Guidelines on Corporate Governance for Licensed Islamic Banks (GP1-i) in 2011 and Corporate Governance Policy Document (CGPD) in 2016 to assist Islamic banks with the establishment of good CG, aimed at enhancing the quality of financial reporting and auditing (Bank Negara Malaysia, 2016). These guidelines and policy documents demonstrate the expectation of a board or Audit Committee (AC) to protect auditor's independence. This is achieved through the assumption of responsibility for appointing and remunerating an auditor, as well as offering a neutral vehicle through which an auditor can express their views on the management's policies. Therefore, these types of CG reforms have repercussions for the quality of an audit as well as an auditor's remuneration (audit fees).

Malaysia, a pioneer in Islamic finance and banking, has implemented the Shariah Governance Framework (SGF) in 2010 to establish a credible Shariah governance structure, in addition to the guidelines and policy document on CG (AlQassar & Ahmed, 2022). In 2013, the Islamic Financial Service Act (IFSA) was implemented to standardize all regulations pertaining to the Islamic finance sector. In September 2019, BNM released the Shariah Governance Policy Document (SGPD) to clarify the responsibilities of boards, managerial teams, and SC (Bank Negara Malaysia, 2019). The improved form of governance in Malaysia should allow for more comprehensive monitoring of Islamic Bank (IB) in the country. Consequently, inquiries may emerge regarding the necessity of more extensive audits to improve audit quality alongside comprehensive monitoring. This would subsequently lead to an increase in audit fees from a demand-based perspective. On the contrary, there is also a possibility that more comprehensive monitoring could enhance the credibility of financial reports and strengthen a company's internal controls, causing auditors to reduce their audit effort, which could result in a reduction of the audit fees (risk-based perspective).

Those two conflicting views, demand-based and risk-based perspectives, persist in audit fees research. Furthermore, prior studies have yielded inconsistent results regarding the association between corporate governance mechanisms and audit fees, applicable to both financial and non-financial companies. The demand-based perspective posits that effective corporate governance mechanisms necessitate enhanced audit quality. An enhanced board and audit committee, characterized by diligence, expertise, and independence, will likely require increased audit efforts to safeguard their reputational capital and reduce the risk of expensive litigation. Lower levels of materiality are required, resulting in increased substantive testing and higher fees for audits. Some research supported this notion as their findings are consistent with the demand-based viewpoint (Farooq et al., 2018; Shakhatreh & Alsmadi, 2021).

In contrast, other researchers noted that CG mechanism and audit fees were negatively associated (Farooq et al., 2018). Research has shown that when good mechanisms of governance are present, an auditor reduces the duration of their audit, thus decreasing their fees since it is recognized that the risks of control and financial reporting can be reduced by this form of governance (Boo & Sharma, 2008; Ghosh et al., 2024). AC have the task of assessing how adequate the internal controls are, resulting in systems that are more effective. Therefore, a higher level of internal controls should reduce audit hours and consequently, decrease the audit fees paid to external auditors. Furthermore, previous studies on audit fees have mostly excluded financial institutions from their samples due to the complexity and uniqueness of such institutions. The only study to date that have looked at the factors influencing banks' audit fees is Boo & Sharma (2008), however, this study did not include IB in their samples. In this study, we examine the relationships between audit fees and the characteristics of corporate governance to address a gap in the existing research. To do this, a sample of IB in Malaysia was used.

The definition of CG involves the processes and structures utilized in the direction and management of a company and its affairs, with the aim being to promote the prosperity and accountability of the corporation. The primary goal is to secure long-term advantages for shareholders while taking into account the interests of other stakeholders (Securities Commission Malaysia, 2017). The Cadbury Report (1992) and Hampel Report (1998) of the United Kingdom provided the basis for the development of the MCCG, which was first released in March 2000 (Securities Commission Malaysia, 2017). It portrayed a sound CG framework and classified the principles and best practices of good governance. Crucial amendments were made to the code in 2007, whereby it was revised to strengthen directorial boards and AC. The objective was to ensure that these parties discharged their duties and functions properly. For AC to become effective checks on company management systems, these revisions included the criteria that dictated whether a person was eligible to be appointed to an AC; AC compositions; how frequently meetings should be held; as well as the requirement that members should remain aware of current financial and other issues through ongoing training.

The code was further revised in 2012, 2017 and recently in 2021. The MCCG 2012 highlighted the importance of improving board structure and composition, recognizing directors as active and accountable fiduciaries. The 2017 revision aimed to further improve board independence, composition, transparency, and accountability, while also promoting effective audit, internal control, and risk management (Securities Commission Malaysia, 2017). The latest code update significantly focuses on improving board oversight and integrating sustainability issues into business strategy and operations (Securities Commission Malaysia, 2021).

The main aim of GP1-i is the promotion to IB of the need to adopt proper and high-standard practices of CG. These guidelines illustrate the general principles, the minimum standards and the particular needs of effective CG. These expectations relate to Islamic banking institutions and the holding companies of IB. The general principles in the guidelines address (i) board matters, (ii) management supervision, (iii) audit and accountability, and (iv) openness. The guidelines present general standards, needs and principles that align with those described in the MCCG. GP1-i was superseded by Corporate Governance Policy Document (CGPD) in 2016 (Bank Negara Malaysia, 2016). The emphasis of this policy document was the foundational elements of a bank’s assessments of supervision. This was key to ascertaining how intense a level of supervision should apply to financial institutions. The board roles are reinforced in which the board should be competent, confident and objective in challenging senior management and hold it to account. Hence, this document on policy established various enhanced expectations of the directors with regard to their duties of supervision, as well as a board’s composition.

BNM requires that all IB to comply with all the requirements in the SGF within six months from its issuance in 2010 to strengthen the Shariah monitoring function. The main reason why BNM created an SGF for Islamic banking institutions was to enhance the roles of boards, SC and managerial teams in relation to Shariah affairs. This included improving the crucial functions involved in assuming responsibility for executing Shariah compliance, as well as research-based tasks aiming to attain operating environments based on Shariah. Compliance with Shariah principles would enhance the credibility of Islamic finance organizations, leading to greater acceptance among the general public and financial markets. The SGF was superseded by the SGPD in 2019 with effective implementation starting 1st April 2020.

In June 2013, the aim of the IFSA was to modernize the legal basis and supervisory process governing Malaysia-based IFIs (this included Islamic banking institutions). In IFSA 2013, the emphasis was that the Islamic finance industry should endeavor to be fully Shariah-compliant, based on four key features: a framework for Shariah governance should be developed; Islamic financial transactions should produce contracts based on Shariah standards; the potential concerns of financial institutions, which might impact on depositors' and policyholders' interests, should be addressed through pre-emptive measures; while Islamic financial intermediation should function effectively and efficiently (Alam et al., 2023; Mukhibad & Nurkhin, 2020). The passing of the IFSA led to the repeal of the existing acts, specifically the Islamic Banking Act 1983 and the Takaful Act 1984 (Aslam & Haron, 2020).

BNM published the SGPD in 2019. The objective being to enhance the supervisory accountability of the boards, SC and other main managerial figures, all of whom were to participate in implementing Shariah governance. Additionally, the document highlights SC's impartiality in bolstering sound decision-making procedures and bolstering internal control systems for efficient risk management of Shariah non-compliance. The SGPD 2019 illustrates, more precisely, the tasks of: (i) boards; (ii) SC; (iii) senior managerial teams; (iv) the functions of control; (v) cultural and remuneration-related compliance with Shariah; and (vi) transparent practices and disclosure. The complex nature of the Islamic banking institutions' activities and the recently developed aspects of governance, risk management and compliance meant that the SGPD 2019 gave an outline of the stronger expectations that banks would encounter.

In 2005, BNM issued guidelines for corporate reporting referred to as GP8-i, which were subsequently amended in 2012. The Financial Reporting for Islamic Banking Institutions issued in 2015 subsequently replaced these guidelines, with revisions made in 2016, 2018, and 2019. These policy documents serve as the foundation for how IB reports and financial statements are presented and disclosed. A further aim of the documents was to guide users by facilitating their evaluations and assessments of, first, banking institutions' financial positions and performances; second, how compatible with Shariah the IB and financial companies' actions were; and third, their adherence to the Companies Act 1965 (revised in 2016), Malaysian Financial Reporting Standards (MFRS) and the financial reporting requirements of both Shariah and Bursa Malaysia (Malaysia's stock exchange).

Many indicators are used to measure audit quality. Kasim (2015) explained that the most common indicators for audit quality are auditor's size, audit fees, and auditor's reputation. Some studies on audit quality used the selection of auditors as the indicator (Alia et al., 2024; Duong Thi, 2023; Gerged et al., 2020; Ocak, 2024; Viet Ha et al., 2023). It is often considered that, compared to smaller auditing companies, higher quality audits are offered by big audit firms or industry specialist auditors as they are regarded as possessing better knowledge and expertise (Ferdous et al., 2024). This study selects audit fees as a proxy for audit quality, as all the IB involved engage the Big-Four audit firms as their external auditors. This decision aligns with prior research on audit quality (Alhababsah & Yekini, 2021; Alkebsee et al., 2021; Bhuiyan et al., 2020; Chang et al., 2021; Dong et al., 2024; Khodakarami et al., 2021; Kim et al., 2024; Li & Wang, 2024; Meng et al., 2024; Moussa, 2024; Qian et al., 2024; Sharma et al., 2021; Yamada & Fujita, 2022).

Previous research on audit fees has largely omitted financial institutions from the study sample because of the complexity and distinctiveness of these entities. According to the authors' knowledge, only two studies have examined the determinants of audit fees in banks (Boo & Sharma, 2008; Fields et al., 2004). Fields et al. (2004) examined firm characteristics and audit fees, while Boo & Sharma (2008) extended the research by including CG mechanisms. Unlike non-financial companies, which have been used as samples in prior studies, the banking industry is subjected to stricter regulatory supervision (Boo & Sharma, 2008). Enhanced monitoring and regulations may alter the dynamics of the relationship between auditing and corporate governance as mechanisms for internal and external company oversight. It was not anticipated that CG and the fees for audits would be significantly associated, given that the CG function could be substituted, in part, by regulatory supervision.

According to agency theory, owners and managers may have competing interests when ownership and control are separated. Because of moral hazard and adverse selection, managers might not always behave in the shareholders' best interests (Fama & Jensen, 1983). A manager possesses a greater volume of information compared to a shareholder or auditor. This asymmetry of data may lead to a manager being wary of disclosing internal details, as they may be afraid that these could be utilized for their removal. Therefore, shareholders have to create an effective monitoring mechanism to align managers' performance with their interests and this monitoring mechanism is not without costs.

The audit fee is a significant component of these monitoring expenses since auditors must audit the financial statements and make sure management act in the best interests of shareholders (Alves, 2023). Existing research provides two perspectives; demand-based perspective and risk-based or supply-based perspective. The former was founded, for the most part, on agency theory. This describes how a board exhibiting a more robust focus on monitoring is likely to require a higher-quality audit, thus incurring higher fees for its audit. Audit fees are deemed proxies for the efficiency of an audit. The latter perspective suggests that a higher fee for an audit might not directly correlate with a higher-quality audit (Ghafran & Sullivan, 2017). Audit fees that arise from a function of production, whereby a robust environment of control is present, cause the level of control risk (as assessed by an external auditor) to decrease. This reduces the extent of the substantive testing and lowers audit fees.

Aslam & Haron (2020) argued that when Islamic banking institutions contain a multiple group of active participants, each of whom functions as a mechanism monitor, systems of corporate and Shariah governance may operate effectively. Those participating encompass boards AC and SC, as well as external and internal auditing parties. Therefore, it can be anticipated that when they effectively practice governance mechanisms, Islamic banking institutions might affect audit processes as they would require higher-quality audits (demand-based perspective). It is important that this study acknowledges the relevance of agency theory since it offers a description of the connections between the monitoring duties of the Islamic banking institutions' boards, AC and SC, as well as the ways they influence how extensive an auditor's work is and, consequently, the audit fees. Hence, agency issues are mitigated.

Agency theory posits that a smaller board size is suitable as it will reduce the agency monitoring costs and ensure good coordination and communication among the board members (Kaaroud et al., 2020). On the other hand, larger boards are presumed to be better at oversight because they are less likely to be dominated by management. They also require greater assurance on the reliability of financial reports, leading to increased audit fees. This positive relationship has been confirmed by recent findings (Drogalas et al., 2021; Farooq et al., 2018; Kalia et al., 2023; Shakhatreh & Alsmadi, 2021; Idzniah & Bernawati, 2020). Based on this reasoning, the hypothesis is as follows:

H1: Board size positively influences audit fees.

According to agency theory, an independent board can lessen opportunistic managerial practices and the misappropriation of company assets by effectively monitoring company operations (Fama & Jensen, 1983). Independent directors have a role of guardianship, protecting shareholders' interests (against agency issues). Additionally, a firm's value can be enhanced with the benefit of their experience. The demand-based perspective involves the anticipation that a higher-quality audit as a tool for monitoring would be demanded by an independent board as they tend to aim to limit agency costs and safeguard the shareholder interests (Shakhatreh & Alsmadi, 2021). Numerous studies have established a positive link between board independence and audit fees (Farooq et al., 2018; Kalia et al., 2023; Mitra et al., 2019). These findings suggest that independent boards prioritize high-quality audits to safeguard their reputation and reduce litigation risks (Farooq et al., 2018). Hence, the hypothesis is articulated as follows:

H2: Board independence positively impacts audit fees.

In GP1-i, it is stated that within Islamic banking institutions, an AC has the responsibility for monitoring the checks and balances so that the reporting is transparent. Thus, it is recommended that the AC shall consist of at least three members. According to Afenya et al. (2022), a larger AC is probably going to improve the quality of financial reporting. To achieve the Islamic banking institutions' checks and balances, an AC requires higher-quality audits and audits of a longer duration, which raises the audit fees. Contradictory findings exist in prior research: while some found no association between AC size and audit fees (Ghafran & Sullivan, 2017; Kaaroud et al., 2020; Mitra et al., 2019), others identified a positive relationship (Drogalas et al., 2021; Januarti et al., 2020). Accordingly, the hypothesis is as follows:

H3: AC size positively influences audit fees.

Per GP1-i, AC members should include at least one finance or accounting expert. Bursa Malaysia also requires ACs in listed firms to have a minimum of three members, one of whom must be part of an accounting body. Financially skilled ACs are more likely to recommend extensive internal and external audits, potentially leading to higher fees. However, empirical findings are mixed, with some studies reporting no significant relationship (Ghafran & Sullivan, 2017; Xue & O'Sullivan, 2023) and others identifying either negative (Hansen et al., 2021) or positive correlations (Joshi et al., 2021; Mitra et al., 2019). Based on these insights, the hypothesis is:

H4: AC expertise positively impacts audit fees.

Agency theory emphasizes that including independent directors on the AC strengthens its ability to oversee financial reporting and external audits. ACs with a higher proportion of independent members are more effective at addressing agency problems and minimizing conflicts of interest (Galal et al., 2022). Furthermore, if the AC contains independent directors, the internal control system would be further strengthened; this would reduce both the inherent and control risks, as well as decrease the substantive testing level, and consequently incurring lower audit fees. MCCG 2017 (Securities Commission Malaysia, 2017) recommends a step-up practice where the AC should consist of only independent directors. This step-up practice is an enhancement from the previous version of MCCG, which only required the AC to comprise at least three members of which the majority are independent directors. Studies on the relationship between AC independence and audit fees have shown mixed results: some report no significant relationship (Mitra et al., 2019), while others find either a positive (Joshi et al., 2021) or negative association (Boo & Sharma, 2008; Fields et al., 2004). Boo & Sharma (2008) noted that effective ACs provide reliable financial data, lowering risks and reducing audit efforts. Accordingly, this study proposes the following hypothesis:

H5: AC independence negatively influences audit fees.

The frequency of AC meetings held over the course of a year is the most widely cited proxy for AC diligence. In alignment with the risk-based approach, a more diligent and proactive AC is anticipated to mitigate financial reporting issues, leading to a reduction in audit fees. Frequent meetings enable ACs to stay updated on current accounting and auditing developments, allowing timely identification and resolution of potential issues (Kaaroud et al., 2020). Empirical findings on the relationship between AC meetings and audit fees are mixed: while some studies show a negative relationship (Afenya et al., 2022; Farooq et al., 2018), others report no significant association (Boo & Sharma, 2008) or a positive one (Drogalas et al., 2021; Januarti et al., 2020). Therefore, the hypothesis is stated as follows:

H6: AC meetings positively impact audit fees.

In the SGPD 2019, it was suggested that for SC to be effective, it should comprise no fewer than five individuals, most of whom should hold Shariah qualifications. It also permits one SC member to serve on the board to bridge SC and board functions. Due to limited research on the connection between SC size and audit fees, earlier findings offer some insights. Kasim (2015) found no significant relationship between SCs and audit fees. Conversely, Aslam & Haron (2020) found that larger SCs can reduce earnings management practices in Islamic banks, which may lower control risk assessments by auditors and lead to reduced audit fees. Therefore, the hypothesis is framed as follows:

H7: SC size negatively impacts audit fees.

According to SGPD 2019, SC must consist of a Shariah qualified Chairman and the majority of them must be Shariah qualified persons. Members who are experts possessing skills, knowledge and experience in Islamic finance can also be part of the SC. As with SC size, little is known about the connection between audit fees and SC expertise. Consequently, the relevant prior studies are utilized to better understand the relationship between SC with accounting/finance expertise in relation to audit fees. Mersni & Othman (2016) reported a negative relationship between SC members with accounting expertise and earnings management, implying that their presence reduces control risk evaluations and audit fees. Kaaroud et al. (2020) also noted a slight negative relationship between SC expertise and audit report lag, suggesting shorter audit durations may lower fees. Based on these observations, the hypothesis is as follows:

H8: SC expertise negatively influences audit fees.

RESEARCH METHOD

Sample Selection and Data Collection

The current study utilized secondary data as the primary information source to investigate the relationship between corporate governance mechanisms and audit fees for IB in Malaysia. This research analyzes the annual reports of 16 IBs in Malaysia over a seven-year period from 2011 to 2017. This study comprises 112 observations. The annual reports can be accessed on the websites of the IBs. The data were extracted manually from the annual reports of the IBs. The data extracted are both financial variables (i.e. total assets, non-performing loan and audit fees) and non-financial variables (i.e. BODs, AC and SC).

Model Specification and Variable Measurements

Consistent with previous study (Boo & Sharma, 2008), the regression model for audit fees is specified as follows:

AF = f (Size, Risk, Corporate governance variables)

$AF = \beta_0 + \beta_1 (IBSIZE) + \beta 2 (NPL) + \beta 3 (BODSIZE) + \beta 4 (BODOUT) + \beta 5 (ACSIZE) + \beta 6 (ACEXP) + \beta 7 (ACOUT) + \beta 8 (ACMEET) + \beta 9 (SCSIZE) + \beta 10 (SCEXP) + \varepsilon$

Where:

AF	: The natural log of the external audit fees paid by the company.
IBSIZE	: The natural log of IBs' total assets.
NPL	: The normal score of the percentage of non-performing loans.
BODSIZE	: The total count of directors serving on the board of IBs.
BODOUT	: The ratio of independent directors to the total number of directors on the board of IBs.
ACSIZE	: The natural log of the total members in the AC of IBs.
ACEXP	: The percentage of AC members possessing professional qualifications such as CPA, CA, or memberships in recognized accounting bodies like MIA or MICPA.
ACOUT	: If all the AC members are independent, it is assigned as 1, otherwise 0.
ACMEET	: If ten or more meetings are held by an AC during a financial year, this is designated as 1, otherwise 0.
SCSIZE	: If the total count of SC members in the IB is five or more, it is assigned as 1, otherwise 0.
SCEXP	: If there is a SC member possessing an accounting qualification, it is assigned as 1, otherwise 0.

The Hausman test determines the appropriate model selection between fixed effects and random effects. The result is significant (0.0182). Therefore, this study uses the fixed effects model. The values of R2 overall and R2 between are 13.69 per cent and 40.80 per cent, respectively. The Serial/Woodridge test yields a significant result (0.0358), suggesting the existence of an autocorrelation issue in the model. Therefore, we proceed by clustering the standard error (which accounts for serial correlation) that can solve the problem of autocorrelation and heteroscedasticity.

RESULTS AND DISCUSSION

Results

Descriptive Statistics

The descriptive statistics for the variables used in the model are shown in Table 1. The findings indicate that external audit fees (AF) have values ranging from RM60,000 to RM771,000, with an average of RM261,780. The highest AF is reported by Bank Muamalat Malaysia Berhad. The board size in the sample is 3 at the minimum and 10 at the maximum, with an average of 6.79. The proportion of independent directors on the board ranges from 0.29 to 1, with a mean value of 0.59. This finding indicates that certain companies continue to fail in adhering to the GP1-i and CGPD mandates regarding the composition of the board, specifically the requirement for a majority of independent directors (Bank Negara Malaysia, 2016). In total, 41 out of the 112 samples do not have a board with independent directors as the majority.

Table 1. Descriptive Statistics

Variables	Mean	SD	Min	Max
Dependent				
Audit Fee (AF)	216.78	147.57	60	771
Control				
IBSIZE	29.46	34.33	2.39	202.49
NPL	0.0234	0.0305	0.0041	0.2323
Independent				
BODSIZE	6.79	1.66	3	10
BODOUT	0.59	0.15	0.29	1
ACSIZE	3.63	1.05	2	7
ACEXP	0.32	0.19	0	0.8
Dichotomous	**Category**	**Frequency**	**Percentage**	**Cum.**
ACOUT	1	60	53.57	53.57
	0	52	46.43	100
ACMEET	1	46	41.07	41.07
	0	66	58.93	100
SCSIZE	1	105	93.75	93.75
	0	7	6.25	100
SCEXP	1	27	24.11	24.11
	0	85	75.89	100

Source: Processed data, 2024

In terms of the AC, the average size for the sample is 3.63, and the range is between 2 and 7. Thus, the CGPD requirement that the AC shall consist of three members at a minimum is complied (Bank Negara Malaysia, 2016). Similarly, the average proportion of AC members possessing professional accounting qualifications is 0.32, with a range from 0 to 0.80. GP1-i and Bursa Malaysia mandate that at least one member of the AC possess a professional qualification as a CPA and/or is a registered member of the MIA, MICPA, or any acknowledged accounting professional body. However, 20 out of the 112 samples still do not comply with the requirements of GP1-i and Bursa Malaysia. Table 1 also shows that 60 samples (53.57 per cent) have all-independent AC members. The results indicate that most IBs in Malaysia have adopted the step-up practice recommended under MCCG 2017 and MCCG 2021. The table also demonstrates that there are 46 samples (41.07 per cent) with 10 or more meetings held during the fiscal year. Regarding the SC, Table 1 shows that 105 samples (93.75 per cent) have five or more SC members. Hence, there are seven samples (6.25 per cent) that do not comply with the SGPD 2019 requirement that the SC shall comprise at least five members. Moreover, there are 27 samples (24.11 per cent) in which the SC members have accounting qualifications.

Correlation Analysis

Table 2 presents the results of the Pearson correlation tests conducted with all variables included. The table indicates that no significant collinearity issues were present among the independent variables. IBSIZE and ACMEET exhibited the highest correlation value of 0.4605. Additionally, a value of 1.67 from the variance inflation factor (VIF) test suggests that multicollinearity among the independent variables is not a problem.

Table 2. Results of Pearson Correlation Test

	AF	IBSIZE	NPL	BODSIZE	BODOUT	ACSIZE	ACEXP	ACOUT	ACMEET	SCSIZE	SCEXP
AF	1										
IBSIZE	0.4555	1									
NPL	0.0634	-0.3211	1								
BODSIZE	0.0858	-0.1831	0.2682	1							
BODOUT	-0.0802	0.2427	-0.1003	-0.4761	1						
ACSIZE	0.3375	0.377	0.0265	0.2964	0.179	1					
ACEXP	0.2051	0.1634	0.0322	-0.0276	0.2372	0.1021	1				
ACOUT	-0.3703	0.04	-0.1309	-0.0073	0.0425	-0.4449	-0.0497	1			
ACMEET	0.2164	0.4605	-0.0746	-0.1378	0.366	0.4339	0.1149	-0.2781	1		
SCSIZE	0.1036	0.2894	-0.1231	-0.0098	0.1761	0.1599	0.233	-0.0185	0.2156	1	
SCEXP	-0.0504	0.0031	0.1514	0.0195	-0.0071	0.1051	0.167	-0.0194	0.1235	0.1455	1

Source: Processed data, 2024

Panel Data Regression Analysis

Table 3 indicates that AC independence (ACOUT), SC expertise (SCEXP), and the log of bank size (IBSIZE) are significant in explaining AF. ACOUT and SCEXP are significantly negative at 5% and 1% levels, respectively, whereas IBSIZE is significant positive at the 1% level. The significant negative relationship between ACOUT and AF supports hypothesis 5 (H5) and is consistent with a prior study on the banking industry (Boo & Sharma, 2008). The negative sign shows that IBs with all-independent AC members will pay lower audit fees. Similarly, the significant negative relationship between SCEXP and AF supports hypothesis 8 (H8) and is consistent with the prior research (Kaaroud et al., 2020; Mersni & Othman, 2016), although the latter found an insignificant result. The negative sign indicates that the existence of at least one SC member with accounting qualifications will decrease the fees for audits. Regarding the significant and positive association between IBSIZE and AF, the finding is in line with prior studies (Ghafran & Sullivan, 2017).

Table 3. Result of the Regression Model

(fixed effect model with clustered standard errors)

Variables		**Coefficients**	**z-value**	**P- value**
(Constant)		2.087	2.13	0.05
Independent variable				
H1	BODSIZE	-0.042	-1.43	0.172
H2	BODOUT	0.378	1.43	0.172
H3	ACSIZE	0.012	0.08	0.938
H4	ACEXP	0.143	1.2	0.249
H5	ACOUT	-0.08	-2.15	0.049**
H6	ACMEET	-0.043	-0.6	0.556
H7	SCSIZE	-0.071	-0.87	0.399
H8	SCEXP	-0.136	-3.61	0.003***
Control variable				
IBSIZE		0.333	3.46	0.004***
NPL		-0.091	-1.88	0.079
N		112		
F-value		7.84		
P-value		0		
R^2 Overall		13.69%		
R^2 Between		40.80%		

Source: Processed data, 2024

Discussion

To discuss the regression findings further, the finding regarding AC independence is consistent with Farooq et al. (2018) and similar to the prior study on conventional banking (Boo & Sharma, 2008). The results reveal a strong negative relationship between AC independence and audit fees in Islamic banks, thereby supporting H5, which hypothesizes this association. Boo & Sharma (2008) highlighted that auditors consider the strength of corporate governance when determining the audit scope, as demonstrated by the significant negative association between AC independence and audit fees. The presence of independent AC members is perceived to improve the oversight of internal controls and the financial reporting process, leading to reduced audit effort. Thus, an auditor would probably lower the risk assessment of the audit, which would subsequently reduce the audit evidence collection and limit the fees for the audit. This finding also provides support for the step-up recommendation of MCCG 2017 and MCCG 2021 that the AC should comprise solely of independent directors may be beneficial for IBs as they would bear lower audit fees due to the auditors' perception of lower control risk. This interpretation aligns with the risk-based perspective and can be consistently linked with agency theory, suggesting that a reduced risk assessment by an auditor and the increased credibility of a client's internal control system would result from robust CG. This would reduce both the effort needed in the audit and the external auditors' fees.

The variable of SC expertise exhibits a significant and negative association with audit fees. Although IBs are not mandated to appoint a SC with financial expertise, the findings suggest that the SC should include members with accounting or finance qualifications to enhance their comprehension of technical issues pertaining to these fields. Consequently, H8, which posits a negative relationship, is supported. The connection may stem from the SGF 2010 requirement, now updated to SGPD 2019, mandating that Shariah audit findings be reported to the AC and SC. Consequently, an increase in detected Shariah issues correlates with a greater potential for resolution of those issues.

The finding is also consistent with Mersni & Othman (2016), which found a significant negative link between SC members with accounting qualifications and earnings management. The reduced earnings management practice can cause the auditor to assess the client as having lower control risk, which will reduce the audit fees. Furthermore, Kaaroud et al. (2020) investigated audit report lag in Malaysian Islamic banks and found a negative, though statistically insignificant, relationship between SC expertise and ARL. A shorter duration of external auditors' engagement implies a reduction in audit fees. This observation aligns with the risk-based approach, which links effective corporate governance to lower audit fees.

Overall, this empirical study found that two CG variables, namely AC independence and SC expertise, can influence the audit fees of IB in Malaysia. On the other hand, the current study noted how the majority of the variables of CG were not significantly related to the fees for audits. This may indicate that more extensive audits are not demanded by the agents of internal governance in the field of Islamic banking. The view of Boo & Sharma (2008) was that this could be explained by their recognition of an overlap between regulatory supervision and the monitoring of audits. If this indeed duplicates oversight efforts, partial substitution may affect regulatory supervision and audit monitoring. A banking institution's failure can have a systemic impact on the whole economy and trigger an economic crisis. Therefore, the regulators also have the interest to oversee the banking institutions closely. IB might be able to accept less expensive external auditor monitoring because regulatory oversight is already in place.

CONCLUSION

The current study identifies a significant negative correlation between AC independence and audit fees. When external auditors recognize that an independent AC is capable of effectively managing internal controls and overseeing financial reporting, the assessed audit risk is reduced. This lowers the extent of evidence collection required and consequently decreases audit fees. Similarly, the study finds a significant negative relationship between SC expertise and audit fees. This may be due to the requirement for Shariah audit findings to be reported to both the AC and SC, which helps expedite the identification and resolution of financial issues related to Shariah compliance. In summary, the findings underscore the risk-based perspective as predominant in Islamic banking institutions in Malaysia, where robust corporate governance mechanisms are linked to reduced audit fees.

The findings of the study also link to the benefits of the step-up practice, as the MCCG 2017 and MCCG 2021 recommended, in terms of the need to establish AC that comprise only independent directors. This might ensure effective monitoring and reduce the risk of control, cutting the costs of external audits. The results also suggest that if SC contain members with accounting qualifications, this might ensure that the IB or finance company is Shariah compliant, while it would also limit the external fees for audits. In terms of research limitation; Firstly, the generalizability from the findings of this study is only possible for IB, since other financial bodies were not included in the sample. Second, this study only focused on the Malaysian context. As a result, the study findings might not be applicable to Islamic banking institutions outside Malaysia, which may have different policies, regulations, and organizational systems. Moreover, this study tested eight CG variables to explain their associations with audit fees. Therefore, future research can expand the possibilities by adding other CG variables to capture their associations with audit fees.

List of Abbreviations

MCCG	: Malaysian Code of Corporate Governance
BNM	: Bank Negara Malaysia
IB	: Islamic Bank
SGF	: Shariah Governance Framework
IFSA	: Islamic Financial Service Act
SGPD	: Shariah Governance Policy Document
CG	: Corporate Governance
SC	: Shariah Committee
AC	: Audit Committee
BOD	: Board of Directors
GP1-i	: Guidelines on Corporate Governance for Licensed Islamic Banks

Authors' Contribution

Conceptualization –VV, MA; Data curation – MA, HAA; Formal analysis – VV; HAA; Funding acquisition – MA; Investigation – VV, MA, HAA; Methodology – VV, MA, HAA; Project administration – VV, MA; Resources – MA, HAA; Supervision – MA, HAA; Validation – HHA; Visualization – MA, VV; Writing – original draft – MA, VV; Writing – review & editing – MA, HAA.

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