

AUDIT COMMITTEE CHARACTERISTICS AND AUDIT FEES OF QUOTED COMPANIES IN NIGERIA: AN EMPIRICAL INVESTIGATION

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Abstract

This study empirically examines the impact of audit committee characteristics on audit fees in 36 quoted firms in Nigeria over the period 2010 to 2017, using descriptive statistics, correlation matrix and OLS and multivariate panel data estimation technique, after conducting the Hausmann, test of correlated random samples, wherein the fixed effect model was selected as the appropriate model, the empirical results revealed that audit committee characteristics have positive and significant impact on audit fees of quoted firms in Nigeria. In particular, audit committee size, audit committee financial expertise, audit committee independence and audit committee meetings have positive and significant effect on audit fees in Nigeria. Against the backdrop of these findings, we recommend amongst others; the entrenchment of sound audit committee with requisite characteristics that will guarantee clear oversight functions, effective internal control and reliable financial reporting in line with regulatory requirements and corporate code of conduct. This will ender such companies to the investing public through greater public confidence and financial reporting quality and integrity

Keywords: *Audit committee characteristics, Audit fees, Corporate code of conduct, Panel Data*

Introduction

The nexus between audit committee characteristics and audit fees has occupied the front burner of empirical researcher in recent time. Audit fees is the remuneration for audit services provided by external auditor that is directed connected to the audit function. It is distinguished from non-audit fee which relates to payment for services other than audit function, such as human resources management, tax advisory services, financial consultancy service, e.t.c (Abbot & Parker, 2000; Bedard, Chtourou & Courtean, 2004).

In general, the link between audit committee and audit fee stem from two perspectives, namely the demand for services by the client and the supply of audit services by the external auditor. From the demand side, the presence of an audit committee may be positively related with audit fees by ensuring that audit hours, for instance are not

reduced to a level that compromises the quality of audit. In this direction, audit committee members have incentives to ensure a high quality audit in order to reduce the risk of litigation and loss of reputation in the event of fraudulent financial reporting. Hence, firms with effective audit committees demand high credibility from their auditor to preserve their reputation and avoid potential litigation leading to higher audit fee (Carcello & Neal, 2003).

On the supply side, audit committee's involvement in strengthening internal controls may lead the external auditor to reduce the assessed level of control risk. As a result, the auditor's reliance on internal controls should result in less substantive testing, and thus a lower audit testing (Collier & Gregory). The supply side thus regard audit committees as an internal control mechanism that influences the nature and extent of audit testing.

In firms with effective audit committees, auditors will reduce their audit risk assessment, leading to lower level of audit testing and lower external audit fees. The essence of audit committee characteristics in examining the effect of audit committee on audit fees is imperative, given the fact that key audit committee characteristics rather than mere presence of an audit committee critically affect the audit committee's ability to effectively execute its duties (Abbott et al. 2003). Regulators on their part, emphasize the need for audit committee to have specific characteristics, such as audit committee independence and financial expertise, e.t.c, and to meet frequently to effectively discharge their duties (Abbott, Parker & Peters, 2004). This is buttressed by prior findings which show that these characteristics influence audit committee effectiveness than mere presence of audit committee (Carcello & Neal, 2003; De-Zoort & Saltiero, 2001).

Prior studies examining the link between audit committee effectiveness and audit fees have found mixed and inconclusive evidence (see Carcello & Nagy, 2004; Abbott et al. 2003; Lee & Mande, 2005; Vaefas and Waegelein, 2007). In addition, while the impact of audit committee characteristics on audit fees have been widely investigated in the developed countries (see Sharma, 2003; Goodwin-Stewart & Kent, 2006; Stewart & Munro, 2007), it has not received any notable empirical attention in a developing country like Nigeria. This paucity of empirical evidence and the mixed and inconclusive findings on the subject matter warrant further empirical examination of the audit committee-audit fee nexus. This is the focus of the study.

Aside the introductory section, the paper is organized as follows. Section two consists of literature review which considers key theoretical and empirical issues on audit committee characteristics and audit fees. Section three contains the methodology, model specification and data. Section four contains the empirical results and analysis and section five contains the conclusion and policy recommendations.

Literature Review

Conceptual Issues

Audit committee characteristics are integral aspect of corporate governance geared toward having an effective audit committee that is able to discharge its mandate and responsibilities efficiently with respect to the possession of intrinsic and valued characteristics. In defining audit committee, emphasis is usually placed on its composition and functions. According to Marian (1988), it is "A committee of the board normally comprising three to five directors with no operating responsibility in financial management. Its primary tasks are to review the financial statements, the effectiveness of the company's accounting and internal control systems and the findings of the auditors to make recommendations on the appointment and remuneration of the external auditors".

According to Richard (1993), "An audit committee consists of a group of senior staff chaired by the chief executive officer or his deputy. The committee's responsibility is to safeguard the independence of the internal audit function and ensure continual improvement in management performance and accountability by seeking action on internal audit and external audit reports". In general an audit committee is a sub-committee of the board of directors of a company, usually constituted from non-executive directors and charged with issues of financial reporting, internal control systems and audit, and to act as a link between the board of directors, internal and external auditors, as means of maintaining financial integrity through the improvement of financial reporting quality. Audit committee thus constitute a more efficient mechanism than the full board on issues relating to financial reporting quality and safeguarding the integrity of the company's financial reporting (Ramsay, 2001).

Audit Committee in Nigeria

The Companies and Allied Matters Act, 1990 states that a public limited company should have an audit committee of a maximum of six members of equal representation of three members, each,

representing the management/directors and shareholders. The members are expected to be conversant with basic financial matters. The committee has the following objectives;

- (i) Increasing public confidence in the credibility and objectivity of published financial statements;
- (ii) Assisting the directors, especially the non-executive directors in achieving their responsibilities of financial reporting;
- (iii) Strengthening the independent position of a firm's external auditors by providing an additional channel of communication.

The function of the committee includes:

- (i) Provision of oversight functions on effective internal control, reliable financial reporting that must comply with regulatory requirements and corporate code of conduct;
- (ii) Review not only external auditor's reports but in addition, the report of the internal auditors;
- (iii) Maintain a constructive dialogue with external auditors and the board in order to enhance the credibility of financial disclosures.

Theoretical Framework

The theoretical support for the formation of audit committee is found in the agency theory.

Agency theory spelt out the relationship between the principals (owners of firms), such as shareholders and agents such as the company executives and managers". In line with the theory, shareholders who are the owners or principals of the company, hires the agents to perform work. They delegate the running of business to the directors or managers, who are the shareholder's agents. Thus, an important responsibility is placed by the principals on agents. The agency problem has been thought to come about by the separation of ownership and control, and the fact that management has more insider information, this leads to owners incurring costs in order to monitor the affairs of the agents (managers). The agency theory expects the agents to act and make

decisions in the principal's interest. On the contrary, the agent may not necessarily make decisions in the best interests of the principals. The managers might put their interests over those of the owners and this might mean overstating or understating numbers reported, corporate governance would help alleviate these agency problems (Chi-Keung & Brossa, 2013). Thus, in agency theory shareholders and debt holders who act as principals seek to obtain maximum benefit from management acting as their agent.

In agency theory, the agent may succumb to economic self-interest, opportunistic behaviour and falling short of congruence between the aspirations of the principal and the agent's pursuits. This theory states that for tasks and responsibilities assigned to employees or agents, they are held accountable. Employees must put in place a good and working corporate governance structure rather than just meeting the needs of shareholders, which maybe working against the governance structure. Due to the separation between ownership and management, the shareholders are unable to directly observe the actions of management (Jensen & Meckling, 1976). Hence, a system of corporate governance control is established on the behalf of the shareholders to discourage managers from pursuing objectives that do not maximized shareholder's wealth. These controls are aimed at either aligning managers' and shareholders incentive or limiting the opportunistic activities of managers. The agency hypothesis posits that the role of audit is to alleviate information asymmetry between insider-managers and outsider-shareholders. If this hypothesis is valid, then an auditor's effort (audit intensity) should be higher in an organization with more severe information asymmetry (Carcello & Neal, 2004, Carcello & Nagy, 2004).

Empirical Literature

Sharma (2003) use evidence from Australia finds a positive and significant relationship between audit fees and a 3-way three way interaction between audit independence, expertise and

meeting frequency. A possible explanation for this is an apparent trade-off between audit committee diligence and the independence and or expertise of members of the committee. For instance, meeting more frequently particularly if the audit partner is present in those meetings may compensate for lack of formal accounting expertise or presence of executives on the audit committee.

Abbott et al. (2003) find a positive and significant relationship between the independence and experience of the audit committee and cost of audit (ie. Audit fees). Similarly, Abbott et al (2004) find that firms with independent and experienced audit committees that meet frequently have a lower financial risk. Lee and Mande (2005) and Goodwin-Stewart and Kent (2006) find that the independence of the board of directors and the number of audit committee meetings have positive and significant impact on audit fees. Some studies have examined the link between audit committee independence, earnings management and earnings quality (see Xie and Daldalt (2003) Bedard, Chtourou & Courteau (2004), audit committee expertise and audit fees (see Xie et al., 2003, DeZoort & Salterio, 2001), audit committee diligence (proxied by frequency or number of meetings) and audit fees (see Yang & Krishnan, 2005), audit committee independence and audit fees (see Klein, 2002; Xie, Wallace & DaDalt, 2003; Carcello & Neal, 2003); Coulton, Craswell & Taylor, 2001) and audit committee size and audit fees (see Xie, et al, 2003; Yang & Krishnan, 2005, Sharma, 2008).

Stewart and Munro (2007) using experimental design find that participants expect audit committee to increase audit fees when the frequency of meetings are high. Muniandy (2007) using Malaysian data finds the existence of CEO duality on the board (a proxy for board independence) is positively associated with higher audit fees. Yatim et al (2006) employing panel data from Malaysian firms find that audit fees are positively and significant related to board independence, audit committee expertise and frequency of audit meetings.

In general, two different perspectives exist in the audit fee literature- the demand-based perspective and the audit-risk perspective. The demand –based

perspective (see Goodwin-Stewart & Kent, 2006) suggests a positive association between audit committee characteristics and audit fees. Firms with strong audit committees demand additional assurance from their auditor to preserve their reputation and avoid potential litigation (Carcello & Neal, 2003, 2004; Abbott et al. 2003). On the other hand, the audit risk perspective (see Muniandy, 2007) proposes that auditors see audit committees as an internal control mechanism that influences the nature and extent of audit testing. In firms with string audits committee, auditors will reduce their audit risk. This, consequently reduce their audit testing, leading to lower external audit fees.

Methodology

Population and Sample

The population of this study is the entire listed firms in the Nigerian Stock. A sample of ten (40) firms on the basis of size and data availability are selected using random and purposive sampling techniques. The period for the study is seven (8) years covering 2010 to 2017.

Variables Description.

In this study, audit fee is used as the dependent variable. The independent variables are audit committee size (ACS) measured as number of individuals on the audit committee, audit committee financial expertise (ACEXP) -measured as the percentage of committee members with accounting background (ie. conversant with financial statements), audit committee independence (ACIND) -measured as members who are non-executive and directors measured and audit committee meeting- measured as the number of times the audit committee meets in a year (i.e frequency of audit meetings). The selection of the variables is in line with the extant theoretical and empirical literature.

Model Specification

The model specified in this study demonstrates audit fees is a function of audit committee characteristics, namely audit committee size (ACS), audit committee financial expertise (ACFE), audit committee independence (ACIND) and audit committee meetings (ACMET). The

functional form of this model will is thus expressed as:

$$\text{AUDFEE} = f(\text{ACS}, \text{ACFE}, \text{ACIND}, \text{ACMET}) \quad (1)$$

Where; AUDFEE=Audit fee

ACS=Audit committee size

ACFE= Audit committee financial expertise

ACIND= Audit committee independence

ACME= Audit committee meeting

The econometric form of the model can be specified as:

$$\text{AUDFEE}_{it} = \alpha_0 + \alpha_1 \text{ACS}_{it} + \alpha_2 \text{ACFE}_{it} + \alpha_3 \text{ACIND}_{it} + \alpha_4 \text{ACMET}_{it} + \varepsilon_{it} \quad (2)$$

Where all the variables are as earlier defined.

ε_{it} =random error term

Method of Estimation

The model specified in (2) is based on the panel regression analysis procedure that is adopted in this study. The main advantage of the panel data analysis is that it comprehensively takes the individual characteristics of the different firms used in the study. It is generally observed that firm-level behaviour is a strong factor in the determination cross-sectional behavior. This differentiation may bring endogeneity bias into the estimation. The panel data analysis helps to correct this inherent estimation problem. The basic class of models that can be estimated using panel technique may be written as:

$$Y_{it} = f(X_{it}, \beta) + \delta_i + \gamma_t + \varepsilon_{it} \quad (3)$$

The leading case involves a linear conditional mean specification, so that we have:

$$Y_{it} = X_{it}'\beta\delta_i + \gamma_t + \varepsilon_{it} \quad (4)$$

Where Y_{it} is the dependent variable, and X_{it} is a vector of regressors, and ε_{it} are the error terms for $i = 1, 2, \dots, M$ cross-sectional units observed for dated periods $t = 1, 2, \dots, T$. The α parameter represents the overall constant in the model, while the δ_i and γ_t represent cross-section or period specific effects (random or fixed).

A central assumption in random effects estimation is the assumption that the random effects are uncorrelated with the explanatory variables. One common method for testing this assumption is to employ a Hausman test to compare the fixed and random effects estimates of coefficients in order to determine the best model for the financial performance model. This test is also used to examine the randomness of the data distribution in this study. Two techniques are employed in the empirical analysis of this study. These involve the use of descriptive statistics which gives the summary measures and initial characterization of the data series. The second is the panel data estimation in order to investigate the influence of each of the explanatory variables on the dependent variable (Audit fee).

Data Sources

The study utilizes annual time series data mainly from the secondary sources. The underlying data for the variables of interest are obtained from the banks published annual Financial Reports at the Nigerian Stock Exchange (NSE).

Empirical Results and Analysis

Descriptive Statistic

The descriptive statistics for the variables used in the analysis is presented in table 1.

Table 1. Descriptive Statistics

	<i>AUDIFEE</i>	<i>ACSIZE</i>	<i>ACEXP</i>	<i>ACIND</i>	<i>ACMET</i>
Mean	9.74	5.96	0.57	2.88	3.04
Median	10.02	6.00	0.02	3.00	3.00
Maximum	15.62	7.00	0.72	3.21	7.00
Minimum	4.42	1.00	0.00	1.00	0.00
Std. Dev.	4.30	0.53	1.02	1.75	1.94
Skewness	1.83	0.16	1.54	0.78	0.63
Kurtosis	4.24	1.72	2.42	3.92	0.89
Jarque-Bera	19.70	47.23	124.20	64.33	5.42

Source: Author's computation

The descriptive statistics show that the mean value of audit fees measured as the log of audit fees is 9.74. Its median value is 10.02, is an indication there is dissimilarity in audit fees in the cross-sectional firms sampled. Apparently, more firms have higher audit fees than the observed mean value. The maximum and minimum values are 15.60 and 4.42 respectively. The standard deviation of 2.3 indicates that the audit fees of most of the firms clusters around the mean value. The Jacque-Bera statistic of 19.7 is passes that significance test and shows that the audit fees of most sampled firms are not normally distributed an indication of non-symmetric distribution. The mean value of audit committee size is 5.9, with a median value, of 6 which suggest that that the average size of audit committee is six, in line with the SEC corporate governance code. The maximum and minimum values are 7 and 1 respectively. The standard deviation of 0.53 is relatively low and indicates that most firms have their audit committee around six members. The mean value of audit committee experience and financial

expertise is 0.57, an indication that about 57 percent of the audit committee have the requisite accounting background. The maximum and minimum values are 72 percent and percent, respectively. The mean value of audit committee independence is 2.88, with a median value of 3. The maximum and minimum values are 3 and 1, respectively. In general, the data series show high skewness and kurtosis values for audit fees, with significant J-B values; an indication of asymmetric distribution and non-normality of values. The implication of this is that there is heterogeneity among the firms. Endogeneity problem is thus expected, thus necessitating the adoption of the panel data technique for the estimation of the relationships.

Correlation Analysis

In order to examine the nature and degree of relationship among the variables, the correlation analysis is carried out. Table 2 presents the results of the correlation matrix.

Table 2: Correlation Matrix

	<i>AUDFEE</i>	<i>ACS</i>	<i>ACFE</i>	<i>ACIND</i>	<i>ACMET</i>
<i>AUDFEE</i>	-				
<i>ACS</i>	0.07	-			
<i>ACFE</i>	0.22	0.26	-		
<i>ACIND</i>	0.19	0.17	0.16	-	
<i>ACMET</i>	-0.32	0.18	0.29	0.17	-

Source: Author's computation

Pooled OLS and Multivariate Panel Data Results

We presents the Pooled OLS and Multivariate Panel Data results in Table 3.

The goodness of fit for the model is not quite impressive, given the low coefficient of determination of 0.22, which indicates that only 22 percent of the net systematic variations in the audit fees of the selected are explained by the explanatory variables; a clear indication of low explanatory and predictive power of the model. The Durbin Watson statistic shows that the estimated suffers from first order positive correlation. Only the coefficients of audit committee financial expertise and audit committee independence are pass significant test at the 10 percent and 5 percent level respectively. These results are however to be expected, given the fact that pooled OLS technique is used before conducting the Hausman test. The OLS estimates reported above cannot be relied on for policy directions, since the estimates inherently possess endogeneity issues. To address this, the panel data analysis technique is employed in re-estimating the relationships. The standard test for the method of panel analysis is to employ the Hausman to choose the appropriate method of estimation. The results of the tests for the Hausman test is reported in table 2. In the result, the Hausman test (Chi-Square statistic) of 12.44,

with a probability value of 0.02 is significant test at the 5 percent level. Thus, we reject the null hypothesis that unobserved firm specific heterogeneity are uncorrelated with regressors, and thus base our analysis on estimates provided by the fixed effect model, as the random effect estimates are likely to be biased and inconsistent. The estimates provided by the fixed effect is thus relied on for policy purpose.

In the fixed effect results, the diagnostic statistics have improved significantly, compared to the OLS estimates. The adjusted R-squared value of 0.92 clearly shows that about 92 percent of the net systematic variations in the audit fees of the cross-sectional firms are explained by the four regressors. The F- statistic of 35.4 is highly significant at the 1 percent level, and validates the existence of a significant linear relationship between the explanatory variables and the dependent variable, and suggests that the explanatory variables are jointly significant in the determination of the audit fees of the cross-sectional firms over the period. The Durbin Watson statistic of 1.75 shows that there is no serial correlation in the model, implying that the model can be used for structural and policy analysis.

Table 3. Results from Pooled OLS and Panel Multivariate Estimation
Dependent Variable: AUDFEE

Variable	Pooled OLS		Fixed Effect	
	Coefficient	T-Ratio	Coefficient	T-Ratio

C	1.022	1.220	0.631	1.211
ACS	0.186	1.082	0.272	1.854*
ACFE	0.115	1.742*	0.126	2.201**
ACIND	0.031	2.104**	0.240	2.174**
ACMET	0.083	1.273	-2.202	-2.022**
			Hausmann Test= 12.44 (0.02)	
	R ² = 0.22 DW=0.92		R ² = 0.91 F-value =35.4 DW=1.75	

***Statistical significance at the 1% level

** Statistical significance at the 5 % level

* Statistical significance at the 10% level

Standard errors of coefficients in parentheses

Source: Author's computation

In terms of the individual performance of the variables in the model, the coefficients of the independent variables are appropriately signed in line with theoretical expectations. The coefficient of audit committee size is appropriately positive and significant at the 10 percent. This implies that large audit committee size will induce high audit fees, the impact which is however not significant. This finding is in line with the findings of Coulton et al. (2001) and in contrast to the findings of Xie et al. (2003). The coefficient of audit committee financial expertise is positive and statistically significant at the 5 percent level. Thus, the greater the financial expertise and experience of the audit committee, the greater the audit fees. Relevant experience and knowledge in accounting and audit matters are considered important in the execution of audit functions as it enables members to be more conversant with financial and operational reports, and enable them execute their oversight functions effectively. This therefore calls for higher audit fees. The finding supports the findings of Lee and Mande (2005). The coefficient of audit independence is positive in line with theoretical expectation and passes the

significance test at the 5 percent level. Invariably, the greater the independence of the audit committee represented by high numbers of non-executive members, the larger the audit fees. The findings buttress the findings of Abbott et al. (2003). Finally, the coefficient of audit committee meetings is positive and significantly related to audit fees. Thus, the greater the frequency of audit meetings, the larger their remuneration (i.e audit fees). The findings support the result of Stewart and Munro (2007).

Conclusion

The importance of sound and well –composed audit committee with requisite characteristics to the success of any firm in terms of good financial reporting quality, oversight functions and financial integrity of any firm cannot be over-emphasized growth and performance. As a string corporate governance structure and institutional and regulatory requirement, a good audit committee is a sine-qua-non for the success of any quoted firm. Given this submission, the investigation of the nexus between audit committee characteristics and audit fees is an important issue in the

corporate governance literature of firms. This study has examined the impact of audit committee characteristics on audit fee, using evidence from 36 quoted firms selected on the basis of data availability and firm size in the Nigerian Stock Exchange (NSE), the empirical findings reveal a positive and significant relationship between audit committee characteristics and audit fees in Nigerian quoted firms. In particular, audit committee size, audit committee financial expertise, audit committee independence and frequency of audit committee meetings are found to be positive and significant variables influencing audit fees of quoted forms in Nigeria.

Against the backdrop of these findings, it is recommended that sound and requisite audit committee characteristic be ensured in any audit committee in line with corporate governance and institutional requirement as enshrine in the Securities and Exchange Commission (SEC) regulatory standard. In this regard, audit committee should ensure the provision of sound oversight functions on effective internal control and reliable financial reporting in line with regulatory requirements and corporate code of conduct. If this translates to high audit fees, stakeholders will be more satisfied that the financial reporting is reliable rather than having unreliable financial reporting at the expense of cheap audit fees.

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