

# Monitoring Costs of Multinational Companies: An Agency Theory Perspective

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## ABSTRACT

This paper investigates the agency costs of multinational companies (MNCs) in relation to agency theory, in the Malaysian business environment. Using the data of 235 MNCs, this study explores their demand for monitoring costs and these companies' preferences between the monitoring costs components. The result indicates that MNCs incur significantly higher monitoring costs compared to domestic companies. However, the relationship between these companies and their preference between the components of the monitoring mechanisms, that is between directorship and auditing as their monitoring mechanism, is not significant. When the auditing components are further investigated, it reveals that MNCs incur more external audit costs compared to internal audit costs.

**Keywords:** Agency Costs, Directorship, Domestic Companies, External Audit, Internal Audit, Monitoring, Multinational Companies

**JEL Classification:** G30, G34, M42

## 1. Introduction

With globalisation, the number of international organisations is steadily increasing. It is claimed that the importance of multinationalisation is growing exponentially and it plays an increasingly important role in businesses (Chang & Taylor, 1999). The dramatic global developments encourage companies to do business across their national boundaries. In addition to selling their products abroad, more organisations are setting

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up production facilities across national boundaries to avail business and investment opportunities (Rahman, 2004).

It is claimed that foreign investment is one of the major sources of sustainable economic growth in transition economies (Yudaeva, Kozloz, Melentieva, & Ponomareve, 2003). This is because these investments bring foreign technologies into the country and facilitate knowledge exchange, and adoption of modern production techniques via copying of foreign production methods and technological know-how, as well as add to the country's managerial capital. Foreign investment is also said to increase competition and stimulate the process of innovation, improvements in product design and output composition.

Yudaeva et al. (2003) also found that foreign owned organisations tend to be more productive than domestic ones. These companies are called 'multinational companies' (MNCs). MNCs are defined as groups of geographically dispersed and goal-disparate organisations that include their headquarters and their different national subsidiaries (Ghoshal & Bartlett, 1990). These companies have different cultural values and involve different ethnicities, which may cause interpersonal conflicts. However, the parent companies find that by investing in foreign subsidiaries they increase the risk of return on their investment. Nevertheless, they are willing to take the chance. It is further claimed that, in order to ensure that the organisation's objectives as a whole are achieved, the parent company will increase its control over the foreign subsidiaries to reduce the uncertainty of these investments. According to Baliga and Jaeger (1984), the heart of control is the monitoring process. Many studies have been conducted to examine these MNCs. However, most previous studies focus on the productivity of MNCs (Yudaeva et al., 2003), ownership by MNCs (Chang & Taylor, 1999), performance of MNCs (Boardman, Shapiro, & Vining, 1997), capital structure of MNCs (Mitto & Zhang, 2008; Aggrawal & Kyaw, 2010) and corporate governance of MNCs (Luo, 2005). Little attention is given to the monitoring costs involved in managing the MNCs. Thus, this study is conducted to examine these monitoring costs.

In addition, it is also claimed that the number of MNCs has increased in developing countries, thus this study will focus on MNCs in Malaysia, which is one of the developing countries in Asia. Statistics show that in Malaysia, foreign investment is significant in contributing to its economic progress by assisting in technology transfer, joint venture, licensing, franchising, management contract, technical service contract, marketing contract and international subcontracting (Beaumont, 1990;

Rahman, 2004). A study of Malaysian companies by Ramasamy (1999) revealed that the number of MNCs in Malaysia has increased. It is further reported that foreign direct investment (FDI) is on an increasing trend in Malaysia with an average annual rate of 8.2 per cent, which is from RM3.8 billion in 1983 to RM6.1 billion in 1989, and this value is tripled in 1994 to RM18.3 billion (Rahman, 2004). According to the Malaysian Investment Development Authority (MIDA), a total of RM66.4 billion investment in 2011 (44.7 per cent) is contributed by MNCs which have chosen Malaysia as their global operation hub (MIDA report, 2012). MIDA also reported that Malaysia was ranked the third largest recipient of FDI among the ASEAN countries, after Singapore and Indonesia in 2011. It is reported that FDI outflow from the developing countries rose by 20.9 per cent in 2010 compared to 2009 which reflect the strength of economics and growing aspiration to compete in new markets. Malaysia was the second largest source of FDI outflows after Singapore in 2010 with USD13.3 billion worth of investment (MIDA report, 2012). Thus, this study recognises investments by MNCs in Malaysia by investigating their monitoring costs.

The monitoring costs used in this study focus mainly on the costs of monitoring mechanisms as outlined by the Malaysian Code of Corporate Governance (MCCG, 2012). These variables and measurements were also used in a similar study by Anderson, Francis, and Stokes (1993). Anderson et al. (1993) carried out their study using Australian PLCs data set in the 1987 fiscal year. The study focused on one independent variable only, that is the organisation's production investment attributes, which is proxied by the degree to which organisation value is determined by assets-in-place versus growth options. The results support the hypotheses that overall monitoring expenditures decrease as the firm has relatively more assets-in-place, that relatively more auditing (compared to directorships) occurs for firms with greater assets-in-place, and relatively more internal auditing (compared to external auditing) also occurs for firms with greater assets in-place. The present study uses the basic analysis of Anderson et al. (1993), by employing Malaysian PLCs data set. This study is important because across countries, differences in governance system, and market factors, political, legal and regulatory framework as well as internal control systems, may influence the agency cost and monitoring mechanism chosen by each organisation in each country (Jensen, 1983).

Furthermore, apart from using the basic analysis reported by Anderson et al. (1993), this study uses other sets of variables. It also

includes a more comprehensive set of organisational attributes that affect the monitoring mechanism chosen by the organisations, together with a broader set of control variables. Some of the organisational attributes in relation to the demand for monitoring mechanisms, such as asset structures have been documented in the literature (Anderson et al., 1993). However, other attributes such as multinational status have received little attention in prior studies in terms of their relationship with the demand and preference for monitoring by the three mechanisms of directorship, internal audit and external audit. Instead of using total assets to market value of the organisation as the production investment attributes (as used by Anderson et al., 1993), this study uses total assets to represent the size of the organisations. Size is one of the control variables. The other control variables are the complexity, growth and listing status of the organisations.

The Malaysia Code of Corporate Governance (which was introduced in 2000 to raise the awareness and practice of good corporate governance by companies in Malaysia) has highlighted the importance of directorships, internal audit and external audit in its principles and best practices of corporate governance. In 2007, the revised version of the Malaysian Code of Corporate Governance was released and a key amendment was the mandatory requirement imposed for the board to establish an internal audit function and to identify a head of internal audit who reports directly to the audit committee. The Code was revised again in 2012 (MCCG 2012) after taking into account changing market dynamics, international developments and the need to continuously recalibrate and enhance the effectiveness of the corporate governance framework (Ho & Taylor, 2013). The new guidelines provide more room for the board to accelerate the efficiency process in the companies for reviewing strategies and reports from individual corporate departments. The new set of roles stressed that there be a separation of tasks between the CEO and chairman in the firms. The new guidelines help to mandate the board in establishing a nominating committee with enhanced roles chaired by an independent director (Alnasser, 2012).

The three mechanisms (directorship, internal audit and external audit) have also been recognised by the Institute of Internal Auditors Malaysia (IIAM) as the important cornerstones in order to achieve good corporate governance (Ravendran, 2005; Singh, 2005). The Malaysian Institute of Accountants (MIA) has also stressed their roles in corporate governance, especially after the Asian financial crisis in 1998 (Liew, 2007), and prior literature has endorsed the importance

of these monitoring mechanisms in ensuring corporate governance of companies (Sam, 2007; Liew, 2007; Dechow, Sloan, & Sweeney, 1996). Despite the importance placed on these three mechanisms by the Code, the IIAM, the MIA and prior studies, there is no study which examines the demand and preferences for these three mechanisms, especially in relation to multinational companies. Other prior research has focused on one specific monitoring mechanism such as external audit only (Che Ahmad, 2001; Anderson & Zeghal, 1994; Lin & Liu, 2013, Hay, 2013), internal audit only (Anwar, 2006; Soh & Martinov-Bennie, 2011; Seol, Sarkis, & Lefley, 2011) or board of directors only (Bezemer, Peij, Kruijs, & Maasen, 2014; Abels & Martelli, 2013; Lam & Lee, 2012;). Thus, this study is carried out to explore the relationship between the multinational status of the organisations and the costs of these three monitoring mechanisms.

This study attempts to address the scarcity of research in this area and contributes to the literature of corporate governance of MNCs in developing countries. In addition, by examining the relationship between these monitoring costs and multinational status, the monitoring mechanisms can be further evaluated and improvised by the regulators. The findings can also help the stakeholders and the organisations to better understand the economic rationale for each monitoring mechanism, and the roles they play in the corporate governance of a multinational company.

This paper proceeds as follows: Section 2 gives a review of the relevant literature which leads to hypotheses development, and Section 3 provides a description of the methodology used for this study. Section 4 presents and discusses the results of the empirical analysis, and finally the last section concludes the study.

## **2. Literature Review and Hypotheses Development**

### **2.1. Agency Theory and MNCs**

Previous studies claim that the monitoring of MNCs can be done through the extended agency relationship between a corporation and its subsidiaries. The extended agency relationship between a corporation and its foreign subsidiaries is described by Ekanayake (2004) as the two levels of principal-agent relationship that exist in the management control system, that is between the organisation's owners (the principal) with the top management (the agent), and between the top management

(acting as principal) and the divisional managers, as the agents who manage the decentralised units. This extended relationship is also believed to affect the monitoring costs of the organisation because of its cultural distance, strategic and operational role, and commitment and psychological alignment, which are critical in influencing goal incongruence and information asymmetry within the headquarters-foreign subsidiary relationship (Roth & O'Donnell, 1996; Egelhoff, 1984; Luo, 2005; Niemi, 2005).

The agency theory models the relationship between principals who engage the agents to perform some services on their behalf, and this may involve delegating some decision making authority to the agents (Fama, 1980; Jensen & Meckling, 1976). Human beings are assumed to be risk averse and self-interested by nature (Eisenhardt, 1989). Therefore, there is a high potential for agents and principals to differ in their preferences for outcomes (Fama, 1980) where the agents may make decisions that reduce their own risks at the expense of the principal. However, principals will not be able to control the agents' behaviour; they can only bear the risk and uncertainty about what the agents are actually doing, and this is called "agency cost". In a domestic company, this relationship can be clearly seen in the shareholders and CEO / management relationship, where the management may decide to invest in projects with negative or sub-optimal present value in order to maximise their own interest (Jensen & Meckling, 1976). However, in a complex organisation of multiple business units and layers of management, the CEO can be viewed as the principal as he is most directly charged with looking after the interest of the organisation as a whole, and the managers of various sub-units held by the corporation are considered the agents (Chang & Taylor, 1999). Under this extended relationship, managers of the sub-units may attempt to maximise their self-interest and the interest of their sub-units, even though this may have a negative implication on the corporation as a whole. Chang and Taylor (1999) further describe the relationship between the headquarters (the principal) and its foreign subsidiaries (the agent) under this extended agency theory, where the parent company invests funds and resources in the subsidiaries and the subsidiaries in turn are expected to work for the benefit of the parent headquarters. However, the geographic distance and national adaptation requirement between the headquarters and their foreign subsidiaries may increase the corporate headquarters' uncertainty about the appropriateness of the subsidiaries decisions (Luo, 2005).

Roth and O'Donnell (1996) claim that cultural distance, strategic and operational roles, and commitment and psychological alignment are critical in influencing goal incongruence and information asymmetry within the headquarters-foreign subsidiary relationship. This is supported by Niemi (2005) who argues that foreign subsidiaries require additional control over management because of conflict of interests between the management of the subsidiaries and the foreign corporate owner may be magnified by geographical distance and national objectives.

Some MNCs resort to monitoring the subsidiaries through staffing control, which is by appointing managers/ directors whose nationality is the same as that of the headquarters. This is consistent with the concept of behaviour control, where the managers/directors are expected to be more likely to act in accordance with headquarters' interests than the foreign managers (Egelhoff, 1984; Baliga & Jaeger, 1984; Chang & Taylor, 1999). This has been exercised by Japanese MNCs, where they are said to use their parent nationals extensively in their top and middle management position in all their foreign operations (Tung, 1984). Therefore they can monitor the subsidiaries through the directors that they choose and appoint. Eisenhardt (1989) supports this move by citing that another way of monitoring is to invest in monitoring systems such as budgetary system, board of directors and additional layers of management. However, MNCs also need to look for other kinds of control and monitoring as MNCs may be forced to utilise more local managers and fewer expatriates, due to pressures from the host country to limit expatriate employment. Another solution to this is for the MNCs to choose auditing as their monitoring mechanism. This is supported by Baliga and Jaeger (1984) who view control as the monitoring processes used by MNCs to verify that the activities and decisions of the different affiliates yield results consistent with the organisation's overall goals and strategies. One of the ways to verify the activities of the subsidiaries, which is normally used by organisations, is through auditing (external and internal auditing).

In a Malaysian study by Che Ahmad, Houghton, and Mohamed Yusof (2006), the researchers argue that foreign companies will incur more agency costs as the distance of the headquarters induces a higher level of management monitoring and provides incentives for them to hire quality auditors. This is supported by an earlier study in the United States, by Eichenseher (1985), who claims that MNCs tend to employ quality and brand name auditors.

## 2.2. *Hypotheses Development*

A MNC is defined as a group of geographically dispersed and goal-disparate organisations that include its headquarters and different national subsidiaries (Groshal & Bartlett, 1990), with different ethnicities and cultural values intertwined which may cause interpersonal conflicts. To ensure this goal is achieved, the parent company will attempt to increase control over its foreign subsidiaries to reduce the uncertainty of its investments. It is believed that foreign subsidiaries require additional control over their management because of the conflict of interests between the management of the subsidiaries and the foreign corporate owners, as magnified by geographical distance and national objectives (Egelhoff, 1984; Niemi, 2005). Egelhoff (1984) also claims that the complex environment of MNCs and the physical and cultural distances make control and monitoring for the parent-subsidiary level a much greater problem in multinational companies than in domestic companies. Therefore, it is argued that companies with foreign subsidiaries or companies with multinational status will demand a different level of monitoring mechanisms as compared to domestic companies. In other words, the multinational status of the organisation will affect the organisation's demand for monitoring mechanisms.

The headquarters of MNCs would also be concerned with sub-optimisation where the actions taken should be beneficial to the subsidiary as well as for the organisation as a whole. However, managers of subsidiaries may favour the perceived interest of the national subsidiary rather than the overall interest of the organisation. Consequently, it is argued that the need for monitoring is higher in foreign subsidiaries of MNCs than in domestic subsidiaries (Egelhoff, 1984; Niemi, 2005). This is supported by Luo (2005) who claims that the complexity of global operation, task programmability and behaviour verifiability when an organisation becomes more globalised are more difficult to monitor and will increase agency costs. Hence, it is hypothesised that:

H<sub>1</sub>: A multinational company has a greater total monitoring cost (from directorship and auditing) compared to a domestic company.

Previous literature also argues that MNCs report their results in more detail compared to companies operating in one country only (Jaggi & Low, 2000). Logically, when more details are reported, there will be more items for the auditors to audit, which lead to more audit effort



to be put in, and consequently more audit fees will be charged. Niemi (2005) also claims that audit fees should be higher for the subsidiaries of foreign companies than their domestic counterparts because of the added complexity in their financial reporting structure and greater need for corporate governance in foreign subsidiaries. This is particularly due to the fact that additional sets of financial statements may be prepared in multiple languages and involve foreign currency transformation and transfer pricing, which will require additional audit effort/ procedures and fees.

In addition, Luo (2005) cites that one of the effects of global competition for MNCs on corporate governance is its monitoring mechanism. As the competition is getting tougher, the agency's global organising and decision making should be largely output-based. Since this requires operational flexibility of the foreign subsidiaries, the power should be decentralised. Therefore, the need for an assurance system such as auditing, is important to ensure that the power delegated is not misused and the decisions made by the managers /directors of the subsidiaries are in the best interest of the organisation as a whole. It is argued that in this circumstance, the independence and opinion of the auditors is highly valued as a monitoring mechanism to be emphasised when compared to a directorship. Therefore, it is hypothesised that:

H<sub>2</sub>: A multinational organisation has a relatively lower expenditure on monitoring from directorship compared to auditing (internal and external).

It is also argued that in a foreign-subsidiary relationship, the distance of the headquarters induces a higher level of management monitoring and this further provides incentives for them to hire quality and brand name auditors (Che Ahmad et al., 2006). Brand name auditors are likely to be hired due to the perceived needs of international standards and high quality auditing of these organisations, which operate internationally and involve complex transactions (such as consolidated accounts, more detail reporting and currency transformation). This is supported by Eichenseher (1985), who found strong evidence of the tendency of MNCs to employ brand name auditors as compared to domestic companies. Hence, it is argued that in a MNC, the need for an assurance system from a third party that is independent of the organisation, such as external auditing is valued more highly than internal auditing, to ensure that the complex transactions are being monitored with care. This is also because internal auditors are viewed as less independent than external auditors, due to the

fact that internal auditors are the staff of the organisation and report to the management of the organisation (Johnstone, Gramling, & Rittenberg, 2014, p. 762). In addition, parent companies would normally request that a brand name auditor with an international reputation (Che Ahmad et al., 2006) be appointed, to ensure that the decisions and transactions carried out by the subsidiaries are in the best interest of the organisation as a whole, and consistent with international standards. Therefore, it is hypothesised that:

H<sub>3</sub>: A multinational organisation has a relatively lower expenditure of monitoring from internal auditing, compared to external auditing.

### **3. Data and Methodology**

#### **3.1. Data and Sample**

The data for the study were collected using primary (questionnaires) and secondary sources (annual reports). The data for the study could not solely be obtained from secondary sources, as some of the information required (such as internal audit costs) was not available from secondary sources (such as annual reports). Unlike information on directors' remuneration and external audit costs, companies were not specifically required to disclose their internal audit costs. Thus, questionnaires were used to obtain this data. Further, the questionnaires were distributed to solicit and verify information on the directors' remunerations, internal audit costs and external audit costs specifically for the financial year ended 2006. The questionnaires were mailed to all companies listed on Bursa Malaysia, other than companies classified under the finance sector. The finance companies were excluded due to their unique features and business activities, as well as differences in compliance and regulatory requirements (Mustapha & Che Ahmad, 2011). Questionnaires were mailed to 867 companies listed on the Bursa Malaysia. Follow-ups were made after three weeks and six weeks of mailing the questionnaires. The response rate was 27 per cent, with 235 usable samples used in the study.

Once the questionnaires were returned, the information relating to the external audit costs and directors' remuneration in the questionnaires were checked and matched to the amount shown in the annual reports of the respective companies. After the figures were verified, it could be concluded that the information given in the questionnaires for the internal audit costs was also for the same period and for the correct company. The annual report was further scrutinised for further information. Information on the company's total assets, total inventories

and total receivables were extracted from the financial statements and notes to the accounts. Multinational status of the company was obtained from the segmental reporting of the company and notes on subsidiaries in the notes to the accounts and further supported by the information in the shareholdings statistics. Information needed to calculate Tobin's Q was extracted from the financial statements. This approach was also used in Anderson et al. (1993) to examine the monitoring costs and demand for monitoring by companies in Australia.

The data were collected in July 2007, which is before the global financial crisis 2007/2008 and the revision to MCCG in 2007. Thus, this study is important as it provides information about the monitoring costs before the financial crisis and MCCG revision in 2007. Further studies can be carried out to examine and compare the monitoring costs before and after the global financial crisis, and before and after the MCCG revisions in 2007 and 2012. The data collected from the responses and annual reports were analysed using regression analysis.

### 3.2. Models and Variable Definition

There are three models to test the three hypotheses. There are three dependent variables, one dependent variable for each model.

The first model tests hypothesis 1 ( $H_1$ ):

$$\text{MONITOR} = a_i + b_1\text{MNC} + \gamma(\text{Control variables}) + \varepsilon_i \dots\dots\dots \text{Model 1}$$

Where the dependent variable is the monitoring costs of companies listed on the Bursa Malaysia. Directorship and auditing (internal and external) are specified as monitoring mechanisms in the Malaysian Code of Corporate Governance (FCCG, 2001). The total monitoring costs (MONITOR) is measured by the sum of organisational investment in non-executive directors' remunerations, internal auditors' costs, and external auditors' costs.

The second model tests hypothesis 2 ( $H_2$ ):

$$\text{DIRAUD} = a_i + b_1\text{MNC} + \gamma(\text{Control variables}) + \varepsilon_i \dots\dots\dots \text{Model 2}$$

Where the dependent variable is the ratio of total directors' remuneration to total auditing costs. This model tests the hypothesis relating to the preference between directorship and auditing.

The third model tests hypothesis 3 ( $H_3$ ):

$$\text{INT EXT} = a_i + b_1 \text{MNC} + \gamma(\text{Control variables}) + \varepsilon_i \dots\dots\dots \text{Model 3}$$

Where the dependent variable is the ratio of the total internal audit costs to total external audit costs. This model tests the hypothesis relating to the preference between internal auditing and external auditing.

The independent variable in all models is the multinational status of the company (denoted by MNC) which is a dummy variable, where one (1) represents a company with multinational status, while zero (0) is for a non-multinational company or a domestic company.

Previous studies define a MNC as any company with production facilities in two or more countries (Martinez & Ricks, 1989), but under one guiding direction (Galbraith, 1978). Some studies emphasise the extent of control over the foreign affiliates where MNC should own and control value-adding activities in more than one country, and ownership of production and service facilities is a necessary pre-requisite of a MNC (Ramasamy, 1999). Hence a mere investment holding company across the border will most probably fail to meet this pre-requisite, as it may not exert effective control over the affiliate company. Thus, this study defines a MNC as a company which operates in at least two countries (as defined by Martinez & Ricks, 1989; Galbraith, 1978), and its parent company holds at least 20 per cent equity in its international subsidiaries (as used by Ramasamy, 1999; Rahman, 2004) or control at least 10 per cent of its assets (as used by Michel & Shaked, 1986; Collins, 1990).

The control variables in this study are size, complexity, growth and listing status. These variables are not the focus of the study, and are chosen based on prior literature (Roth & O'Donnell, 1996; Anderson & Zhegal, 1994; Tauringana & Clarke, 2000; Che Ahmad, 2001; Khan, Dharwadkar, & Brandes, 2005).

## 4. Findings and Discussions

### 4.1. Descriptive Statistics

Table 1 presents the descriptive statistics of the variables used in the study. The raw data indicates that the sample companies cover a wide range of companies, from small to relatively large companies, ranging from those with RM18 millions to RM65,092 millions in total assets. The complexity of the companies (COMPLEX) in terms of their operations ranges from simple, where there are companies with only their head

office with no subsidiary, to many subsidiaries. The complexity of their assets' compositions also reflects the same pattern and the average for the ratio of inventories and receivables to total assets is about 31 per cent. The average Tobin's Q (GROWTH) of 1.05 is approximately close to the earlier findings of 1.13 in Haniffa and Hudaib's (2006) study. About 42 per cent of the companies have multinational status, and this is slightly lower than the 47.5 per cent MNCs reported by Ramasamy (1999) on Malaysian companies. The data were cleaned from outliers and the data for MONITOR, INTEXT, SIZE and COMPLEX were transformed into logarithm format to control for violation of OLS regression assumptions relating to normality and homoscedasticity. The data were checked for normality. The results of standard tests on skewness and kurtosis for the dependent variables and the independent variables indicate that there is no problem with normality assumption and the variables can reasonably be considered as normally distributed.

Table 1: Descriptive Statistics of the Sample Companies

Variable	Mean	Std Dev	Skewness	Kurtosis
MONITOR	12.9841	1.0005	0.864	0.922
DIRAUD	9.7291	7.4972	1.190	1.516
INTEXT	0.5959	0.4098	1.437	2.777
MNC	0.4200	0.4940	0.339	-1.902
RECINV	0.3088	0.1945	0.329	-0.888
COMPLEX	2.4998	0.9091	0.232	1.430
SIZE	19.744	1.4171	0.911	0.887
LISTSTAT	0.7400	0.4370	-1.130	-0.731
GROWTH	1.0515	0.7092	5.424	42.856

MONITOR = Total monitoring costs(ln); DIRAUD = Ratio of director costs to auditing costs; INTEXT = Ratio of internal audit costs to external audit costs (ln); MNC = MNC (Dummy); RECINV = Ratio of inventories and receivables to total assets; COMPLEX = Number of subsidiaries(ln); SIZE = Total assets(ln); LISTSTAT = Board listing (Dummy); GROWTH = TOBINS'Q

The Pearson's correlation was employed to examine the existence of multicollinearity among the variables. Table 2 shows that all the Pearson's correlation coefficients' absolute values between the independent variables are lower than the threshold value for potential multicollinearity of 0.80 (Gujarati, 2011). Thus, multicollinearity is not found to exist for this set of variables, and this allows for standard interpretation of the regression coefficients. Columns 2, 3 and 4 of Table 2 present the relationship between the independent variable

Table 2: Pearson's Correlation of the Variables

Variable	MONITOR	DIRAUD	INTEXT	MNC	RECINV	SIZE	COMPLEX	GROWTH	LISTSTAT
MONITOR	1.00								
DIRAUD	0.06	1.00							
INTEXT	-0.02	0.05	1.00						
MNC	0.37***	0.00	-0.08*	1.00					
RECINV	-0.21***	0.17***	0.01	0.13**	1.00				
SIZE	0.82***	-0.32***	0.21***	0.28***	-0.40***	1.00			
COMPLEX	0.61***	-0.22***	-0.05***	0.32***	-0.14**	0.52***	1.00		
GROWTH	0.09*	-0.05	0.16***	0.06	0.00	0.05	-0.04	1.00	
LISTSTAT	0.32***	-0.02	0.05	0.10*	-0.23***	0.47***	0.21***	0.06	1.00

MONITOR = Total monitoring costs(ln); DIRAUD = Ratio of director costs to auditing costs; INTEXT = Ratio of internal audit costs to external audit costs (ln); MNC = MNC (Dummy); RECINV = Ratio of inventories and receivables to total assets; SIZE = Total assets(ln); COMPLEX =Number of subsidiaries(ln); GROWTH=TOBINS'Q ; LISTSTAT = Board listing (Dummy);

(MNC) and the three dependent variables (MONITOR, DIRAUD and INTEXT). The relationships between the variables appear to be strong and significant for Model 1 and Model 3, and this is consistent with the multiple regression results in Table 3.

## 4.2. Regression Analysis

### 4.2.1 Total Monitoring Costs and MNC

Table 3 presents the results of the regression analysis. The result in column 2 of Table 3 indicates that companies which have multinational status have higher monitoring costs compared to domestic companies. The adjusted R squared for Model 1 is 0.738 and the F-value of 111.038 is significant ( $p < 0.000$ ). This adjusted R squared means that close to 74 per cent of the variation in the total monitoring costs can be explained by this model.

This result also supports the complex relationship between headquarters and subsidiaries as explained by Ekanayake (2004). Foreign subsidiaries are claimed to require additional control over management because of the conflict of interests between the management of the subsidiaries and the foreign corporate owners, which may be magnified

Table 3: Results of OLS Estimation

Variables	Model 1	Model 2	Model 3
<b>Dependent variable:</b>	<b>MONITOR</b>	<b>DIRAUD</b>	<b>INTEXT</b>
Constant	1.679*** (2.729)	46.29*** (5.481)	-1.846*** (-3.986)
MNC	0.159** (2.116)	1.742 (1.692)	-0.142** (-2.514)
SIZE	0.533*** (16.00)	-1.877*** (-4.106)	0.129*** (5.163)
COMPLEX	0.237*** (5.318)	-0.888 (-1.454)	-0.081** (-2.403)
RECINV	0.476** (2.439)	1.516 (0.566)	0.359** (2.443)
LISTAT	-0.155 (-1.784)	2.943** (2.467)	-0.068 (-1.041)
GROWTH	0.095** (2.001)	-0.635 (-0.974)	0.083** (2.321)
R Squared	0.745	0.144	0.138
Adjusted R squared	0.738	0.121	0.115
F statistic	111.038	6.385	6.079
P value	0.0000	0.0000	0.0000

MONITOR = Total monitoring costs(ln); DIRAUD = Ratio of director costs to auditing costs; INTEXT = Ratio of internal audit costs to external audit costs (ln); MNC = MNC (Dummy); SIZE = Total assets(ln); COMPLEX = Number of subsidiaries(ln); RECINV = Ratio of inventories and receivables to total assets; LISTAT = Board listing (Dummy); GROWTH = TOBINS'Q

Notes: \*\*\* significant at 1% level; \*\* significant at 5% level; \* significant at 10% level

by geographical distance and national objectives (Che Ahmad et al., 2006; Niemi, 2005; Luo, 2005; Egelhoff, 1984) and cultural distance, strategic and operational roles and psychological alignment (Roth & O'Donnell, 1996). Consequently, the need for monitoring is higher in foreign subsidiaries of MNCs than in domestic subsidiaries.

Luo (2005) argues along the same line by claiming that the effects of global competition for MNCs require them to have flexibility in their operations where the power is decentralised. This spurs the need for better assurance and monitoring systems compared to domestic companies to ensure that the power delegated is not misused, and the decisions made by the managers/directors of the subsidiaries are in the best interest of the organisation as a whole. In addition, it is argued that MNCs report their results in more detail compared to companies operating in one country only (Jaggi & Low, 2000). Thus, there is added complexity in their financial reporting structures (Niemi, 2005) which will lead to more monitoring costs.

An independent t-test which examines the multinational and domestic companies is also carried out. It reveals that there is a significant difference between the monitoring costs of MNCs and domestic companies at  $p < 0.001$ . The descriptive statistic reveals that the average monitoring costs for MNCs is RM1,394,463, which is very much higher than the domestic companies' average monitoring costs of RM454,753.

#### *4.2.2 MNC and Preference Between Directorship and Auditing*

Column 3 of Table 3 presents the multiple regression analysis used to test hypothesis  $H_2$ . The adjusted R squared for Model 2 is 0.121 and the F-value of 6.385 is significant ( $p < 0.000$ ). This adjusted R squared means that more than 12 per cent of the variation in the ratio of director costs to auditing costs can be explained by this model. However, the results indicate that multinational status is not a significant factor in the preference between the monitoring mechanisms of directorship and auditing. The results suggest that while monitoring is important (as indicated in the result in Model 1), the preference between directorship and auditing is less clear. Such results deserve further analysis in future research.

#### *4.2.3 MNC and Preference Between Internal and External Auditing*

Column 4 of Table 3 presents the regression analysis used to test the hypothesised variables for Model 3. The adjusted R squared for Model 3 is 0.115 and the F-value of 6.079 is significant ( $p < 0.000$ ). This adjusted R squared means that more than 11 per cent of the variation in the ratio of internal auditing costs to external auditing costs can be explained by this model.

The results in Table 3 relating to multinational and domestic companies indicate that companies which have multinational status have higher monitoring costs in external auditing compared to internal auditing. This variable is significant and in the expected direction, thus hypothesis  $H_3$  is supported. This notion is consistent with earlier studies (Che Ahmad, 2001; Eichenseher, 1985).

The results may be explained by the need for an independent assurance system to check on the management of foreign subsidiaries' operations in multinational settings, as the headquarters need to know whether the overall objectives of the organisation are achieved and whether the shareholders wealth is maximised. Internal audit may



be considered to be less independent compared to external auditors, especially if this function is done in-house. If the function is outsourced, the internal auditors will be reporting to the audit committee, which is a subcommittee of the board of directors of the subsidiary. On the other hand, external auditors are outsiders who report to the shareholders of the company, thus they are viewed to be more independent to report on the subsidiaries' operation to the foreign headquarters compared to the internal auditors.

Furthermore, due to the perceived needs of international standards and high quality auditing of these MNCs, which operate internationally and involve complex transactions (such as consolidated accounts, more detail reporting and currency transformation), it is claimed that headquarters in foreign controlled companies are likely to hire brand name auditors with an international reputation (Che Ahmad, 2001; Eichenseher, 1985).

Another plausible explanation for the higher external audit costs compared to internal audit costs incurred by MNCs, is due to their appointment of brand name auditors with international reputations. This appointment of international auditors may also be due to the fact that the organisations want to portray that their financial reporting is consistent with worldwide standards, with the hope that it can ease their dealing with foreign investors and headquarters or subsidiaries. It is said that auditors with international reputation charge companies at a premium (Pong & Whittington, 1994; Anderson & Zeghal, 1994) which leads to higher external audit costs compared to internal audit costs, and results in a negative relationship as indicated in this study.

## 5. Conclusion

The major purpose of this study is to investigate the demand and preference for monitoring mechanisms by MNCs in the Malaysian business environment. The results indicate that compared to domestic companies, MNCs incur significantly greater monitoring costs. This may be due to the global and complex environment of MNCs and the physical and cultural distances which make control and monitoring for the parent-subsidiary level a much greater problem in multinational than in domestic companies. However, multinational status is not significant when the cost of directorship and auditing are compared. But when internal auditing and external auditing costs are compared, the results indicate that companies with multinational status have

significantly more external auditing costs. The results are consistent with prior studies and this may be explained by the need for an independent assurance system to check on the management of foreign subsidiaries' operations in multinational settings, as the external auditors are viewed as more independent than internal auditors.

The conclusions drawn from this study should be interpreted in a limited way, which would potentially represent opportunities for further investigation in future research. First, this study is a cross sectional study, where it uses one year's data only. Future research could extend the study to include more years of data, thus longitudinal studies can be conducted and further investigation on the impact of the multinational status of the organisations on the demand and preferences for monitoring mechanisms in the short and long-terms can be analysed. Second, future studies can also employ different research methods. Interview sessions can be arranged with those involved in selecting and overseeing the monitoring mechanisms and governance structure of the multinational companies, to enhance understanding on the issue. In addition, detailed investigation of the attributes of MNCs and local domestic companies is also an interesting domain to study in future research.

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