

**THE AUDIT COMMITTEE EXPERTISE
AND
FINANCIAL REPORTING QUALITY**

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Abstract

The objective of the study is to investigate the relationship between audit committee expertise and financial reporting quality. Since Sarbanes Oxley Act 2002, there has been growing interest in the research concerning audit committee expertise. Audit committee plays an important role on the quality and credibility of financial reporting, since they effectively function as a governance mechanism.

Whilst, many studies have examined the attributes of audit committee financial expertise with regard to financial reporting quality, and their composition of expertise on the audit committee board, few have focused on the financial expertise aspect specifically and none have considered extending the meaning of expert other than the notion of a professionally qualified accountant. This study examines the audit committee expertise attribute in detail and investigates the relationship between these expertise attributes and financial reporting quality, and thus, complements extant literature on audit committee expertise. Additionally, the study shows that, the measurement of financial literacy or expertise requires more detailed analysis than previously done as such measures may not be appropriate for Malaysia, an emerging economy. The study highlights that this lack of attention to the appropriate measure of audit committee member expertise may explain why some Malaysian studies failed to find any association of financial expertise with financial reporting quality, suggesting that a more reliable measure is needed.

Two research questions are developed to address the research gap on audit committee expertise. First, to address the issue of a lack of clear definition and appropriate measure of audit committee expertise that is suitable for an emerging economy such as the Malaysian given its corporate governance scenario and inadequate resources specifically in terms of suitably qualified financial experts. Second, to investigate if there is any relationship between these detailed attributes and measures of audit committee expertise and financial reporting quality, which are proxied by fraudulent financial reporting and earnings management. Hence the study contributes to the extant literature of corporate governance specifically applicable for emerging economies by extending the notion of and existing definition of financial expertise in audit committees.

The study draws from three theories, namely, the agency theory, resource dependence theory and behavioural decision theory, to form the framework and develop the hypotheses to be examined. The agency theory theorises that the audit committee acts as a monitoring mechanism on the preparers of financial statements, while the resource dependence theory posits that the director acts as a link between the firm and external resources, and functions as the provider of resources. The expertise element is derived from the application of behavioural decision theory and experts literature. Two separate research samples are used for this study: one for fraudulent financial reporting and the other for earnings management. Fraud firms are selected from the Securities Commission's Announcements and Enforcement Annual Reports, and a matched pair sampling is utilised. Whereas, samples for earnings management involved 2008 financial data of 300 firms that were ranked by highest market capitalisation.

The study is important as it provides additional knowledge about the impact of having audit committee financial experts on reducing the incidence of management fraud or reporting irregularities, and assist practitioners and policymakers, such as Malaysian

Institute of Accountants and Securities Commission, to determine ways to enhance audit committee performance and improve the reliability of financial reporting, as well as improving the quality of the accounting profession.

Abstrak

Matlamat kajian ini adalah untuk menyiasat hubungan antara kepakaran jawatankuasa audit dengan kualiti laporan kewangan. Sejak Akta Sarbanes Oxley 2002 dikenalkan, terdapat minat mendalam berkaitan kepakaran jawatankuasa audit, terutamanya setelah Suruhanjaya Sekuriti Pertukaran Asing Amerika mewajibkan firma-firma untuk mengenalpasti pakar kewangan jawatankuasa audit. Impak jawatankuasa audit memainkan peranan penting terhadap kualiti dan kredibiliti laporan kewangan, kerana merupakan mekanisma tadbir urus yang dapat membaiki operasi dan keuntungan ekonomi di dalam dunia ekonomi baru.

Terdapat banyak kajian yang melibatkan kualiti kepakaran jawatankuasa audit dengan kualiti laporan kewangan, dan komposisi kepakaran di dalam jawatankuasa audit. Akan tetapi, kajian yang khusus mengenai komposisi pakar dalam jawatankuasa audit masih berkurangan, terutamanya dalam melanjutkan definisi kepakaran yang sebenar. Oleh itu, kajian ini ingin menambah kepada kesusasteraan perakaunan, kajian yang menyeluruh berkenaan komposisi kepakaran jawatankuasa audit terhadap kualiti laporan kewangan, dan bertindak sebagai pelengkap kepada kajian terdahulu. Dalam pada itu, ukuran kepakaran jawatankuasa audit adalah perlu untuk dianalisa dengan lebih lanjut kerana definisi yang diberikan Suruhanjaya Sekuriti Tukaran Asing Amerika mungkin tidak bersesuaian dengan Malaysia yang merupakan salah satu ekonomi baru. Atas dasar ini juga, beberapa kajian di Malaysia gagal untuk mengaitkan pakar kewangan jawatankuasa audit dengan laporan kewangan, seperti pengurusan pendapatan. Seterusnya mengiyakan perlunya satu ukuran yang lebih baik diperlukan.

Kajian ini memeriksa hubungan antara kepakaran jawatankuasa audit dengan laporan kewangan berkualiti yang diwakili oleh laporan kewangan palsu dan pengurusan keuntungan. Dengan memperkenalkan ukuran pakar seperti kelayakan akademik dan pengalaman bekerja, kepada definisi kepakaran yang sedia ada, kajian ini menyumbang kepada kesusasteraan dari segi melebarkan maksud kepakaran jawatankuasa audit.

Tiga teori yang digunapakai; teori agensi, teori bergantung sumber dan teori ketentuan tingkah laku, untuk membina rangkakerja dan hipotesis. Teori agensi meramalkan jawatankuasa audit bertindak sebagai salah satu daripada mekanisme kawalan kepada penyedia penyata kewangan. Sementara teori bergantung sumber beranggapan pengarah bertindak sebagai penghubung antara firma dan sumber luar. Seterusnya, teori ketentuan tingkah laku digunakan untuk merangka aspek kualiti pakar. Firma-firma yang terlibat dengan penipuan dipilih daripada Pengumuman dan Penguatkuasaan Suruhanjaya Sekuriti, dan padanan berpasangan dibuat ke atas sampel itu. Manakala, sampel pengurusan keuntungan melibatkan 300 firma teratas dalam pasaran pemodalan bagi tahun 2008.

Kepentingan kertas kerja ini adalah kerana ia memberikan maklumat terbaru tentang impak pakar kewangan jawatankuasa audit dalam mengurangkan insiden yang melibatkan penipuan pengurusan atau ketidaksekitaan dalam laporan. Ia juga membantu pengamal perakaunan dan penguatkuasa seperti Insitutit Akauntan Malaysia dan Suruhanjaya Sekuriti membaiki pencapaian jawatankuasa audit, dan reliabiliti laporan kewangan, sekaligus mempertingkatkan kualiti profesion perakaunan di alaf baru ini.

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LIST OF ABBREVIATIONS

AAER	Accounting Auditing Enforcement Releases
ACCA	Association of Chartered Certified Accountants
ACGA	Asian Corporate Governance Association
ACI	Audit Committee Institute
AICPA	American Institute of Certified Public Accountants
AMEX	American Stock Exchange
AMP	Advance Management Program
ANOVA	Analysis of Variance
ASX	Australian Securities Exchange
AT	Agency Theory
BDT	Behavioural Decision Theory
BM	Bursa Malaysia
BRC	Blue Ribbon Committee
BMSB	Bursa Malaysia Sdn Bhd
CDRC	Corporate Debt Restructuring Committee
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CIA	Certified Internal Auditors
CICA	Canadian Institute of Chartered Accountants
CMA	Certified Management Accountant
CMSA	Capital Market Securities Act 2007
CPA	Certified Public Accountant
DAC	Discretionary Accruals
DBA	Doctor in Business Administration
ED	Exposure Draft
EM	Earnings Management
FFR	Fraudulent Financial Reporting
FRC	Financial Reporting Committee
FT500	Financial Times Top 500 Companies
GAAP	Generally Accepted Accounting Practices
GAAS	Generally Accepted Auditing Standards
GDP	Gross Domestic Products
GLM	General Linear Model
HKEx	Hong Kong Exchange and Clearing Ltd
HKICPA	Hong Kong Institute Certified Public Accountants
IAESB	International Accounting Education Standards Board
ICA	Institute of Chartered Accountants
ICAEW	Institute of Chartered Accountants in England and Wales
ICAI	Institute of Chartered Accountants India
ICANZ	Institute of Chartered Accountants of New Zealand
IFAC	International Federation of Accountants
INED	Independent Non Executive Directors
ISA	International Standard of Auditing
KLSE	Kuala Lumpur Stock Exchange (currently known as Bursa Malaysia)
KPMG ACI	KPMG Audit Committee Institute
MASB	Malaysian Accounting Standard Board
MBA	Master of Business Administration
MCCG	Malaysian Code of Corporate Governance
MESDAQ	Malaysian Exchange of Securities Dealing & Automated Quotation

MIA	Malaysian Institute of Accountants
MICPA	Malaysian Institute of Certified Public Accountants
MSWG	Minority Shareholder Watchdog Group
NAS	Non Audit Service
NASDAQ	National Association of Securities Dealers Automated Quotations
NDAC	Non Discretionary Accruals
NED	Non Executive Directors
NYSE	New York Stock Exchange
NZX	New Zealand Stock Exchange
OECD	Organisation for Economic Co-operation and Development
OLS	Ordinary Least Squares
PhD	Doctor of Philosophy
PN4	Practice Note 4
PPE	Property, plant and equipment
RDT	Resource Dependence Theory
REC	Receivables
REV	Revenues
SC	Securities Commission
SCA	Securities Commission Act 1993
SEC	Securities Exchange Commission
SGX	Singapore Exchange
SIA	Securities Industries Act 1983
SOA	Sarbanes Oxley Act 2002
SPSS	Statistical Package for Social Science
TA	Total Assets
TACC	Total Accruals
UN	United Nations
UK	United Kingdom
US	United States
WEI	World Education Indicators