Chapter 1 INTRODUCTION

1.0 Introduction

This chapter is the introductory chapter for the study. The chapter comprises of the background of study, followed by audit committee research gap, motivation and research objectives and research questions of the study. It also provides a brief overview of the theoretical framework, hypotheses development and methodology. Further, a summary of the research is provided, followed by a discussion on the significance of the study. Finally, the chapter discusses the organisation of study and conclusion.

1.1 Background

In 1999, the Blue Ribbon Committee (BRC) produced ten recommendations concerning the effectiveness of audit committees. Among them, Recommendation 2 relates to the audit committee expertise (BRC, 1999). Subsequently, the Sarbanes Oxley Act introduced in 2002, further enlightens on the role of audit committees, specifically Section 407, on the Disclosure of Audit Committee Financial Expert.

Since Sarbanes Oxley Act (SOA), there has been a growing interest in the research area concerning audit committee expertise, especially as the Security Exchange Commission (SEC) requires firms to identify their audit committee financial experts. Firms with audit committees financial experts are likely to have a high quality of reported earnings (Qin, 2006), and have annualised abnormal excess returns of 4.6% per year than those companies that did not have their directors to improve on their financial literacy (Coates *et al.*, 2007). Further, it is shown that markets react positively to the announcement of directors with accounting financial expertise on audit committee board (Defond *et al.*, 2005). Recent empirical studies, evidenced that audit committees (AC) with more financial experts are associated with less earnings management (Krishnan and Visvanathan, 2009; Jaggi and Leung, 2007; Bedard *et al*., 2004), lower cost of debt (Anderson *et al*., 2004), fewer restatements (Abbott *et al.*, 2004), lower internal control weaknesses (Zhang *et al*., 2007), high quality of earnings (Qin, 2007), larger audit committee size (Saleh *et al*., 2007) and improved governance (Defond *et al*., 2005).

Clearly, the presence of financial experts may enhance and shift the focus of audit committee discussions and overall evaluations of company's financial reporting quality (McDaniel *et al.*, 2002). While, Zhang *et al*. (2007) document that financial expertise in the audit committee is an important determinant of internal control. This is supported by Krishnan and Visvanathan (2009) who document that audit pricing is negatively related to accounting financial expertise in the audit committee, thus, supporting the notion that auditors value financial expertise that is consistent with the SEC's definition of financial expert. Further, firms acknowledge the differential contributions and outside opportunities of board members when, firms with high quality audit committee, i.e. the committee chairs financial expertise, pay a higher level of total compensation to audit committees relative to compensation committees (Engel *et al*., 2010).

Audit committee came into light in Malaysia during the 1980s, following the collapse of a merchant bank in Malaysia (Abdullah, 2007), previously known as Bank Bumiputra Malaysia Berhad. Later, in 1994 Bursa Malaysia had mandated all listed companies to maintain audit committee should consist in majority of non-executive directors. Whereas, in the UK, audit committees received some attention in the early 1990s in connection with the need for greater oversight of both the internal and external audit process and financial reporting disclosures (West and Berman, 2003). Malaysia is an interesting case to study because it is claimed that corporate governance practices used by Malaysian listed companies are different from those practised in developed markets (Yatim *et al*., 2006). Institutional differences exist between developing capital markets, such as Malaysia and other developed markets. Yatim *et al.* also evidenced that the Malaysian corporate environment offers clearly identifiable capital segments divided along ethnic lines, which is consistent with earlier study by Mak and Kusniadi (2005). Additionally, the influence of politics in the corporate sector is inevitable, since Malaysian corporate sector is characterised by the existence of politically favoured corporations (Gul, 2006).

Corporate governance in Malaysia is becoming more apparent, when firms have started to emphasise their corporate governance efforts, for instance scoring in Corporate Governance Initiatives[1] by Bursa Malaysia, and a Malaysian Corporate Governance Index[2] that was introduced in 2009. This is evidenced further when Malaysian corporations produced better accounting results with concentrated ownership (Haniffa and Hudaib, 2006), and ranked 6th (among 11 Asian countries) in terms of CG quality in CG Watch 2007[3] (ACGA, 2007), and this trend is expected to continue in the foreseeable future (Ariff *et al.*, 2007). This makes Malaysia an interesting case study. Furthermore, Malaysia's relatively young capital market and its cultural context, presents an interesting context to study (Zain and Subramaniam, 2007), as certain corporate governance mechanisms (such as internal mechanism and ownership) play an important role in emerging markets (Haat *et al.*, 2006b). The focus with emerging economies, or transition economies such as Malaysia, provide a different economic environment giving rise to pressures to managers to expropriate assets for benefit of

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[1] CG Initiatives are introduced by Bursa Malaysia to raise the standards of CG practices among listed issuers and to improve at international CG ratings.
[2] The new Malaysian Corporate Governance Index developed by MSWG (Minority Shareholders Watchdog Group) to promote best practices in corporate governance among public-listed companies in Malaysia.
[3] This report was produced in collaboration with the Asian Corporate Governance Association (ACGA) and independent non-profit organisation based in Hong Kong.

controlling stockholders or their personal business interests (Chen, Firth, Gao and Rui, 2006) and thus, impacting the financial reporting credibility and quality.

In 1999, a Report of the Finance Committee was submitted to the Ministers of Finance to explain the current state of corporate governance in Malaysia in the aftermath of the regional economic crisis in 1997 and 1998. Even though the real Gross Domestic Product (GDP) growth was below -5 percent in 1998, the Malaysian economic fundamentals remained strong at an average rate of 6.2 percent per annum during the 1991-2005 (Economic Planning Unit, 2006). The crisis exposed serious weaknesses in corporate governance such as weak financial structure, over leveraging by companies, lack of transparency, disclosure and accountability (Rahman and Ali, 2006). In March 2000, the Malaysian Code of Corporate Governance (MCCG) was introduced, to improve investors' confidence towards the companies' governance. The need for a code also resulted from economic forces and to reinvent corporate enterprise to meet emerging global competition. This was followed by Bursa Malaysia's[4] revamped Listing Requirements in 2001, highlighting the importance of corporate governance and disclosure requirements. Hence, the role of the code is to guide the board of directors by clarifying their responsibilities and providing prescriptions, thereby strengthening the control exercised by boards over their companies (Securities Commission, 2007a)[5].

The MCCG was revised in October 2007, involving eleven amendments. Most of the amendments were related to the board of directors, where among the amendments in Part 2 of the Code, on the best practices of corporate governance concerned that "all

[4] Bursa Malaysia is responsible for the front line regulation of its members and of public luisted companies.
[5] Securities Commission (SC) acts as the regulator for the capital market in Malaysia, discharging its enforcement functions over all the regulatory matters under its purview.

members of the audit committee should be financially literate and at least one should be a member of an accounting association or body" (Securities Commission, 2007a, p10). The new amendments support the importance of having an audit committee member who is a member of an accounting association or professional body. Consequently, this raises the issue of whether this requirement is a sufficient guideline for that particular audit committee member to be the financial expert on that committee, or whether it suffices to have an expert from one particular background only, or discipline.

1.2 Research Motivation, Objectives and Research Questions

There have been several studies concerning the attributes of audit committee financial expertise with regard to financial reporting quality, and their composition of expertise on the audit committee board (see Dechow *et al*., 1996; Klein, 2002b; Joshi and Wakil, 2004; Qin, 2006; Rahman and Ali, 2006; Lai and Tam, 2007; Baxter and Cotter, 2009; Engel *et al*., 2010) few have examined the financial expertise composition specifically (such as Qin, 2006; Baxter and Cotter, 2009) and only Engel *et al*. (2010) have considered extending the qualities of an expert, other than as a professionally qualified accountant. This study complements Engel *et al*. (2010) by extending the qualities of experts, in the context of academic qualification, and non-accounting professional experts.

In addition, the measurement of financial expertise may need to be further analysed, as SOA and SEC's description may not be appropriate for Malaysia, an emerging economy, and the need for additional theoretical work to explain the monitoring role of audit committees as proposed by Beasley *et al*. (2009). Which is why, some Malaysian studies (see Iskandar and Abdullah, 2004; Rahman and Ali, 2006; Ismail *et al*., 2008) failed to find any association of financial expertise with financial reporting, hence suggesting that perhaps a more appropriate measure and explanation are needed.

Thus, this study extends the literature by examining the audit committee expertise in relation to financial reporting quality. Thus, it is consistent with Beasley *et al*. (2000), and Abbott and Parker (2000) who document a positive association between independence of the audit committee and the number of audit committee meetings held with the use of an industry specialist audit firm. And complements prior studies on audit committee expertise such as Aier *et al*. (2005), Coates *et al*. (2007), Baxter and Cotter (2009), and Engel *et al*. (2010).

Table 1.1 Motivations, Research Objectives and Questions

Motivations	Research Objectives	Research Questions
Unclear Definition. No studies on extending the qualities of experts other than putting a benchmark on professional qualified accountant, and theoretical explanation for audit committee expertise. *Appropriate Measure.* SOA and SEC's description may not be appropriate for Malaysia, an emerging economy. And a recent call from the latest amendments on MCCG concerning financial literate directors among audit committees.	To investigate types of audit committee experts and examine a more appropriate measurement for audit committee experts.	What will be the appropriate measure of audit committee experts that suits the Malaysian corporate governance practices?
Financial Reporting Quality. Limited studies have examined audit committee expertise with financial reporting quality, especially with fraudulent financial reporting.	To examine the impact of different audit committee experts on financial reporting quality.	Is there a relationship between these audit committees experts and financial reporting quality?

This study is motivated by three key factors as shown in Table 1.1, (1) a lack of clear definition of audit committee expertise, (2) a lack of theoretical explanation for the importance of audit committee expertise in AC, and an appropriate measure of expertise, especially for emerging economy such as Malaysia, and (3) on the relationship or association of these measure for AC expertise in an emerging economy with financial reporting quality, hence leads to two fundamental research questions. The first research question addresses the two key elements of unclear definition and appropriate measure. While the second research question addresses the gap in research relating to financial reporting quality.

1.2.1 Research Question 1

As stated above, research question 1 is derived from two key elements, i.e. unclear definition and lack of an appropriate measure of expertise. Since unclear definition and appropriate measure are interrelated, they lead to a similar objective. Given the limited attention given to formulating an appropriate measure of expertise for an emerging economy like Malaysia, the study extends current literature on audit committee experts, consistent with McMullen (1996) to examine whether there are systematic differences between companies with and without financial reporting problems, in terms of position, independence and experience of audit committee members. This study examines the experience of audit committees in relation to financial reporting quality, supported by Felo *et al*. (2003) who suggest that having more than one expert in accounting or financial management on the audit committee may be beneficial to firms.

The second factor was a call from the recent amendments to the Code of Corporate Governance (MCCG) in October 2007 that explicitly mentioned concerns regarding the financial literacy of every audit committee member and required that at least one member should have a professional accounting affiliation. The revised Code strives to strengthen the role of audit committees by requiring the committees to be comprised fully of non-executive directors. In addition, all of its members should be able to read, analyse and interpret financial statements so that they will be able to effectively discharge their functions (Securities Commission, 2007a).

However, having at least a member with professional affiliation may not be sufficient to carry out the role of being the audit committee financial expert. The aspiring financial expert of an audit committee should have certain characteristics that are also important in addition to the professional accounting affiliation. In light of this, one of the main obstacles to good governance is the limited supply of qualified independent directors (Abdullah, 2009) thus, a call to introduce other characteristics to recognise an expert, and a better measure to capture financial knowledge of directors gained through general and specific experience (Iskandar and Abdullah, 2004) and their academic qualifications. As suggested by McEnrue (1988), organisations should examine the relationship between managers' experience and their performance in formulating promotion, transfer and retention policies. The study extends Singer and Bruhns (1991) study on the effect of academic qualifications on managerial performance. The measure is guided in part by prior literature and theories that capture the current scenario of audit committee expertise in Malaysia, based on the information about directors' information described in corporate annual reports. Further efforts in this area might build an executive profile of firms with quality financial reporting (Peyrefitte *et al*., 2002), and a better understanding of directors' background is necessary to advance management research and promote its relevance to corporate governance practice and reform (Roberts *et al*., 2005). Hence, based on these arguments, the study raises the first research question: “what will be the appropriate measure of audit committee experts that suits the Malaysian corporate governance practices?”

1.2.2 Research Question 2

Subsequently, based on Table 1.1, motivation 3 leads to research question 2. Therefore, the study examines the impact of the audit committee on the quality and credibility of financial reporting (Mangena and Tauringana, 2008), since it plays an important role as part of the governance mechanism to improve operations and economic profit in the emerging markets (Haat *et al*., 2006b). Prior studies such as Bedard and Chi (1993) and Libby and Tan (1994), recommended future research by suggesting that accountants and auditors acquire expertise in order to facilitate the transfer of expertise from experts to non-experts. Libby and Tan (1994) recommend that the focus has moved towards the individual problems of structured tasks and validated constructs. In addition to financial experts, McDaniel *et al*. (2002) suggest that future research investigates how various types of financial experts differ in their reporting quality judgment. Furthermore, there is significant demand for additional research related to financial statement fraud as a proxy for financial reporting quality (Nieschwietz *et al*., 2000). Fraud appears to be the most problematic issue for businesses worldwide, regardless of a company’s country of operation, industry sector or size, as revealed by the PriceWaterhouseCoopers (PWC) 2007 Survey (PWC, 2007). Therefore, the study addresses research question two, i.e. “is there a relationship between these audit committee experts and financial reporting quality?’

1.3 Methodology, Theoretical framework, and Hypotheses

The two research questions above, are guided by three theories: the agency theory, resource dependence theory and behavioural decision theory, to form the framework and develop the hypotheses to be examined. The agency theory theorise that the director or audit committee acts as a monitoring mechanism on the preparers of financial statements (Shapiro, 2005). It is theorised that the presence of independent directors with specific financial training and experience will reduce the incidence of management irregularities (see Jensen and Meckling, 1976; Fama and Jensen, 1983a; Menon and Williams, 1994; Eisenhardt, 1989; Shapiro, 2005). Further, the resource dependence theory posits directors as a link between firms and external resources to gain competitive advantage (Hillman and Dalziel, 2003; Udayasankar, 2008). Subsequently, the underlying assumption for directors with certain qualifications and experience, are supported by the experts literature from behavioural decision theory (see Shepherd and Rentz, 1990; Bonner and Lewis, 1990; Abdolmohammadi and Shantaeu, 1992; Libby and Luft, 1993; Eysenck, 1993; Bonner and Walker, 1994; Choo, 1996; Patel and Day, 1996; Anderson, 2000; Harre, 2002; Rose *et al*., 2007) to support the theoretical background in determining the experts, and introduce new measures of expertise. The study hypothesised firms with more audit committee experts, are more likely to have better financial reporting quality. That is, the more audit committee experts in the board, the less likely the firm will be involved in fraudulent financial reporting, and the lower is the magnitude of earnings management.

Table 1.2 Summary of Hypotheses

Independent Variables		Hypotheses
(1) Professional Accounting Affiliated (2) Postgraduate Qualification (3) Senior Managerial Experience	H1 H2 H3	Firms with higher proportion of audit committee members with professional accounting affiliations (postgraduate qualifications, senior managerial experience), are less likely to experience fraudulent financial reporting.
(1) Financial Expert (A) (2) Accounting Expert (B) (3) Non-Accounting Professional Expert (C) (4) Non-Accounting Expert (D)	H4 H5 H6 H7	Firms with audit committee members with experts (Type A, B, C and D) are negatively related to earnings management.

Two proxies are used as measures of financial reporting quality (POB, 2000; Balsam *et al*., 2003; Cohen *et al*., 2007; Akers *et al*., 2007; Zhao and Chen, 2008), namely, fraudulent financial reporting and earnings management. Prior literature (see Beasley, 1996; Erickson *et al*., 2006; Zhao and Chen, 2008; Owens-Jackson *et al*., 2009) uses match pair sampling with fraudulent financial reporting, while earnings management is a cross sectional data collection. A matched pair sampling is carried out for the sampling consistent with prior studies (see Beasley, 1996; Owens-Jackson *et al*., 2009). However, samples for earnings management are taken from top 300 listed companies that were based on prior year market capitalisation.

A logistic regression analysis is utilised for examining the fraud sample (see Abbott *et al*., 2004; Carcello and Nagy, 2004a, 2004b; Mangena and Tauringana, 2008; Hasnan, 2009), while a linear multivariate analysis is deemed appropriate to analyse the earnings management sample (Davidson *et al.*, 2005; Piot and Janin, 2007; Zhao and Chen, 2009).

1.4 Findings

In the match pair sampling for fraudulent financial reporting, two hypotheses are strongly supported, namely; managerial ownership and accounting affiliated directors. Where, managerial ownership and accounting affiliated audit committees are negative and significantly related to fraudulent financial reporting. On the other hand, earnings management shows that three hypotheses are supported where, accounting affiliated audit committees are negatively related to discretionary accruals. Two control variables – performance (ROA) and leverage – are positively associated with earnings management as expected. Hence, show evidence that professional qualifications are an important determinant in financial reporting quality.

As qualification is shown to contribute to the financial reporting quality, this study lends support to prior studies (McMullen, 1996; McDaniel *et al.*, 2002; Felo *et al.*, 2003) and complements other studies such as Baxter and Cotter (2009) and Krishnan and Visvanathan (2009), by introducing tertiary education academic qualifications as one of the criteria for experts. Baxter and Cotter (2009) identified differences in the association between audit committee and accounting expertise. However, their study uses different definitions of expertise, between two aspects – accounting experts and legal experts. The study also complements the study of Coates *et al*. (2007) and Qin (2006), which is related to accounting financial experts and, similarly Zhang *et al*. (2007), Rahman and Ali (2006), Yang and Krishnan (2005), and Abbott *et al*. (2004). This study extends Baxter and Cotter (2009) and other related studies by examining different types of expertise from financial experts to non-accounting experts (Coates *et al*., 2007; Qin, 2006; Defond *et al*., 2005). Findings suggest that audit committee expertise may also include other non-accounting background disciplines and improve the quality of financial reporting by not only considering directors with accounting certification, but those with senior management experience and postgraduate qualifications as well lends support to Engel *et al*. (2010). Hence, in principle, experts can be measured by academic qualification and work experience gained at senior managerial level.

1.5 Significance of This Study

This study is significant as it has several implications for research. Firstly, it provides further evidence on the role of audit committee experts in reducing the incidence of management fraud or reporting irregularities, consistent with Baxter and Cotter (2009), Beasley *et al*. (2009), Abbott *et al*. (2007) and Rager (2004). This has implications for regulators. Regulators can consider key attributes in appointment of directors with necessary pre requisites such as to include academic qualification and senior managerial experience. Following this, policy makers can ensure mechanisms are in place to train potential directors or existing directors to acquire the attributes of the financial expert, and hence add value to the financial reporting quality. Furthermore, the accounting profession and market regulators can determine ways to enhance audit committee performance and improve the reliability of financial reporting (McMullen, 1996) as well as improving the quality of the accounting profession (IFAC, 2009).

The study extends and confirms prior study such as Beasley *et al*. (2009), that neither agency theory nor institutional theory can fully explain the substantive monitoring of financial reporting, therefore additional theoretical work is needed. Hence, the application of resource dependence theory and behavioural decision theory in audit committee research is also a key contribution to extant literature. The inclusion of resource dependence theory explains the function of directors, specifically audit committee members as the provider of external resources to the firm, in terms of expertise and experience, confirms prior study by Gendron and Bedard (2006) that AC effectiveness to some extent related to the expertise and independence of the audit committee members. Prior audit committee studies that were very much grounded by agency theory, focused on the directors' independence where the directors act as monitoring mechanism. However, they failed to recognise the knowledge and expertise of audit committee members, such as their academic background and work experience. The resource dependence theory and behavioural decision theory provide a different perspective to view this important contribution of audit committee experts in financial reporting, and a shift in the role of audit committees into monitoring mechanism and also as resource provider to the organisation.

1.6 Organisation of Thesis

Chapter 2 discusses the extant corporate governance research with a focus on the audit committee. The aim is to articulate the gap in extant audit committee expertise research and justify the research questions for the study.

Chapter 3 explains the theoretical framework and develops the hypotheses for further examination. It draws upon the behavioural decision theory and expert literature to provide the theoretical foundation for framing the research framework. The agency theory is utilised to explain the fundamental basis of a view of audit committee as an effective mechanism to monitor agent behaviour on behalf of the shareholders' interest, whereas, the RDT is used to explain the function of the boards as a link to external resources, by bringing into the firms expertise and experience (Hillman and Dalziel, 2003).

Chapter 4 involves discussion of method of the study, it explains the methodology applied in the study. Basically it explains the research design of the study, especially on the two proxies used to measure financial reporting quality. Chapter 5, discusses the results from both analysis of fraudulent financial reporting and earnings management. Chapter 6 explains the limitations of the study, and the implications of study for theory, stakeholders, researchers and suggestions for future research.

1.7 Conclusion

The study extends the literature on audit committee expertise composition in relation to financial reporting quality, and complements prior studies on audit committee expertise. The objectives are twofold: firstly to define expertise by drawing on appropriate behavioural theory and provide an appropriate theoretical model to examine the hypotheses. And secondly, to investigate the association between these audit committee experts with financial reporting quality, using two indicators of financial reporting quality, namely, fraudulent financial reporting and earnings management.