Chapter 2 LITERATURE REVIEW

2.0 Introduction

This chapter provides an overview of corporate governance and the development with particular interest on extant studies conducted in developed and emerging economies. It then draws on the extant audit committee expertise literature and identifies research gaps in this area to provide the motivation for this study.

2.1 Corporate Governance Overview

Corporate governance, according to the Organisation for Economic Co-operation and Development (OECD), is about the way in which boards oversee the running of a company by its managers, and how board members are in turn accountable to shareholders and the company (OECD, 2004). And it is viewed as effectively delineating the rights and responsibilities of each group of stakeholders in the company (Ho and Wong, 2001).

Corporate governance is a framework or structures and processes of the organisation, and cannot work on its own without the participation of people within the organisation as well as outside people such as the external auditor. Cohen *et al*., (2004) has identified the players or parties from prior literature that are involved in corporate governance namely; the board of directors, the audit committees, the external auditor and the internal auditors. While Rezaee (2003) mentions a "six-legged stool" instead of four as was mentioned by Cohen. Rezaee (2003) has expanded the parties that are involved with corporate governance by adding another two i.e., top management team and governing bodies. According to Rezaee (2003), for good governance to take place there should be active participation of all parties in fostering continuous improvements,

including the board of directors, audit committee, top management team, internal auditors, external auditors, and governing bodies. Basically, Rezaee adds parties that are involved in all aspect of management, monitoring and control aspect of organisation as well as the environment that governs corporate governance. Whereby, management aspects involved the top management and board of directors; the monitoring and control, from audit committee, internal auditors and external auditors, and the external forces came from governing bodies such Securities Commission in Malaysia. The studies outline the people that helps to ensure the governance process and structure are properly implemented.

Since corporate governance is interrelated with many functions within the organisation, such as internal control and top management, it covers a wide area of jurisdictions, ranging from issues of internal control, audits, organisational structures, board directorship, and management including top management and employees. Similarly, studies that are related to corporate governance have expanded beyond the governance framework and accounting numbers and financial performance. Studies are also expanding into other sectors such as non-profit organisations (e.g. Vermeer *et al.*, 2006), health care and information technology (Valentine and Masters, 2008).

Hence, corporate governance is an issue of great concern as well as a great opportunity for financial and external reporting research. Especially as the wide ranging scope and integrative framework it offers, will provide a basis for directing our focus to major corporate governance issues and responsibilities (Parker, 2007), and motivates entrepreneurial activities which increase the wealth of the business (Keasey and Wright, 1997).

Literature in corporate governance has evolved from disclosure of financial reporting (see Buzby, 1974; Firth, 1978), to fraudulent financial reporting (see Beasley, 1996) and expanded into earnings management (see Dechow *et al*., 1996; Davidson *et al*., 2005). And further, expands into interim reporting (Mangena and Pike, 2005). However, the financial reporting subject gets more scrutiny when earnings management becomes more researched, such as examining cash flows (Dechow *et al*., 1998), free cash flow and debt monitoring (Gul and Tsui, 2001), and on role of accruals with reported earnings (Ball and Shivakumar, 2006). Then, financial reporting issue is expanded to going concern reports (Carcello and Neal, 2003), earnings misstatements (Patterson and Smith, 2003), and restatements (Palmrose and Scholz, 2004; Arthaud-day *et al*., 2006; Durner and Mangen, 2009).

The corporate governance issue also examines areas of internal control and auditing. Beasley and Petroni (2001) examine board independence with auditor type, suggesting that specialisation for auditors is considered important. At the same time, internal control and internal audit starts to expand with audit committee (see Goodwin, 2003) and on internal governance and earnings management (Davidson *et al*., 2005). Auditing also is a well researched area that relates to auditors (Palmrose, 1986; Loebbecke *et al*.,1989), auditing knowledge (Bonner and Walker, 1994), audit pricing (Gul and Tsui, 2001), audit fees (Abbott *et al*., 2003), audit adjustment (Dezoort *et al*., 2003), auditor communication and audit committee (Cohen *et al*., 2007), auditing expertise and performance (Gendron *et al*., 2007) and also audit quality with independence and internal control (Zhang *et al*., 2007), and auditor industry specialisation (Craswell *et al*., 1995; Cenker and Nagy, 2008 and Gul *et al*., 2009). Hence, issue with auditors put the interests of researches because of the independent position they hold to produce quality financial reporting. Studies in auditing range from various topics from behavioural

aspects of the auditor himself, and expands into relationship with other parties such as audit committees, and auditors as industry specialist.

Other important issues of corporate governance, ever since the theory of the ownership structure is introduced by Jensen and Meckling (1976); are board of directors and ownership structure. For instance in Europe, ownership concentration is an interesting issue because investors are mostly individuals and families, (see Tipuric *et al*, 2007; Brouthers *et al*., 2007; and Santiago-Castro and Brown, 2007), and in transition economies where the country is changing from socialism to capitalism. Hence agency problems may arise from the misalignment of goals and objectives between majority and minority shareholders rather than from diverse interest of management and owners. In region of emerging economies, ownership structure is also a well researched topic such as in the Asian region (Hanazaki and Liu, 2007), Hong Kong (Gul and Tsui, 2001; Jaggi and Leung, 2007), and Malaysia (Mak and Kusniadi, 2005; Hashim, 2009).

Board's composition has always sparked the interest of researchers as they represent the shareholders in the organisation, and monitors the resources of the organisation. The focus on board of directors is well researched ever since the 1980s (see Hermalin and Weisbach, 1988; Beasley, 1996; Lee *et al*., 1999; Shivdasani and Yermack, 1999; Beasley and Petroni, 2001; Petra, 2005; Peasnell *et al*., 2005; Nicholson and Kiel, 2007; Ahmed and Duellman, 2007), followed by audit committees that gained interest in the US (see Kalbers and Fogarty, 1998; Spira, 1999; Carcello and Neal, 2000), UK (see Collier and Gregory, 1999; Goddard and Master, 2000) and also Asian countries (Teoh and Lim, 1996; Jaggi and Leung, 2007).

Issues on corporate governance have grown a long way since the 1970s starting from financial reporting, until it evolves to fraudulent financial reporting and earnings management where earnings management later, came up with more rigorous methods introduced by various researchers (see Dechow *et al.*, 1995; Bartov *et al.*, 2001; Dechow and Dichev, 2002; Kothari *et al.*, 2005; Ball and Shivakumar, 2008b) Until recently, corporate governance has expanded from listed companies to mutual funds such as Ferris and Yan (2007), and relates to more common finance subject such as leverage (Nikoskelainen and Wright, 2007) and liquidity (Chung *et al.*, 2010). The ownership structure on the other hand, becomes an interesting topic for selective regions due to the transition economies such in the Europe and emerging economies particularly in the Asian region. Finally, the board's role and composition have always been the key issues in corporate governance, since they are among the parties that involve in corporate governance (Cohen *et al.*, 2004; Rezaee; 2003).

2.1.1 Corporate Governance and Audit Committee

Earlier, Cohen *et al.* (2004) and Rezaee (2003) mentioned of several parties that are involved with corporate governance, where one of them is the audit committee. Cohen *et al.* (2004) adds that, the interactions between audit committees, and other stakeholders are crucial to effective governance highlighting the function of audit committee, showing clearly the audit committee is becoming more important. This became more apparent when issues and recommendations are made following the collapse of Enron early 2000. However, prior researches in relation to audit committee stems from the 1980s, which arises subsequent to corporate failures and had sparked interest of good governance in the United Kingdom and United States.

In the United Kingdom (UK), Cadbury Report was introduced as a response to a number of well publicised corporate problems in the late 1980s that involved creative accounting, and business failures among others (Keasey and Wright, 1997), and highlights the establishment of audit committees that comprise at least three non-executive directors. The Cadbury Report basically focused on the greater monitoring role of non-executive directors and recommended a voluntary “code of best practice” to be implemented along with a statement of compliance reviewed by the auditors and published with the annual financial accounts.

Whereas, in the United States (US), Blue Ribbon Committee (BRC) was introduced in 1999, and provide ten recommendations on audit committee effectiveness. Among the key issues that were included were disclosure and the transparency of good governance. It is considered as the starting point for the development of audit committee guidelines, since it relates to the recognition of the audit committee’s position in the larger governance process and oversight of financial reporting. The BRC also named three main groups that are responsible for the financial reporting process; full board including the audit committee, financial management including internal auditors, and outside auditors. Thus, the key element in board oversight is working with management to achieve corporate legal and ethical compliance. Consequently, board oversight’s duties include, ensuring that quality accounting policies, internal control, independence and objective external auditors are in place to deter fraud, anticipate financial risks, and promote accurate, high quality and timely disclosure of financial and other material information to the board of directors, to the public markets and shareholders (BRC, 1999).

Subsequently, following the Enron saga in 2002, the Sarbanes Oxley Act (SOA) was introduced later to emphasise the independence of audit committees, financial expertise within the audit committee, improvements in the nature and timing of disclosure. The Act focuses on corporate disclosure and governance practices. Consequently, SOA is to improve the integrity and reduce the opacity of financial statements and among the provisions made were requiring management of public companies to provide a comprehensive report on internal control over financial reporting, and certify the correctness of the financial statements, its disclosures and processes to achieve adequate disclosure, and the quality of its internal control.

The audit committee on the other hand, has important oversight roles but does not replace the management's role, whereby they act as an independent check on management. The audit committees rely on internal and external auditors to develop and communicate objective information needed by the audit committee to effectively perform its oversight function. Some of the functions as stated in Gramling *et al*. (2010) are: be apprised of all significant accounting choices made by management, significant changes in accounting systems and controls, have authority to hire and fire the external auditor and review audit plan and audit results with the auditors, and receive all the regulatory audit reports and periodically meet with the regulatory auditors to discuss their findings and concerns. Audit committee that act as the representative of the board of directors, facilitates the efficient and effective functioning of the board in overseeing auditors. According to Rezaee (2007), audit committee is required under the listing standards to implement and support the oversight functions of the board, specifically in areas related to internal control, risk management, financial reporting and audit activities. Hence, the emergence of integrated financial statement audit and internal control over financial reporting, directly affecting the integrity, reliability, quality and

transparency of financial statement audited by external auditor. Therefore, the audit committee has to balance their function between advising management and overseeing their performance in the areas of financial reporting, risk management and internal control.

2.2 Audit Committee Attribute – the Expert

The key to good governance lies in getting the right board in place. The board being accountable for its stewardship, runs the business and assumes responsibility over all of the principal responsibilities to effectively lead and control the company (Finance Committee, 2000). Whereas the BRC (1999) dictates that good governance comes from a board comprising individuals with certain characteristics, such as recognition on the importance of the board's tasks, integrity, a sense of accountability, a history of achievement, and the ability to ask tough questions. Hence, we can see that the Finance Committee and BRC look at the board of directors as a mechanism to achieve good governance. This lends support to the SOA (2002) that also highlight the concern on audit committee financial expertise such as Section 407 on the disclosure of audit committee financial expert.

The financial expertise issue among audit committees has been highlighted in the SOA, and BRC. A study that examined the wealth effects of the passage of SOA 2002 on financial firms, finds that firms with less independent audit committees, without a financial expert on the audit committee and less involved CEO, experience less favourable wealth effects (Akhigbe and Martin, 2006). There is also evidence that suggests audit committees should be composed of directors who are independent and have a financial expert to effectively perform their responsibility and enhancing the credibility of financial reporting as shown in Mangena and Tauringana (2008), and

firms are now acknowledging committee financial experts when higher compensation are paid to them (Engel *et al*., 2010). Previously, Vermeer *et al*. (2006), show that 88 percent of organisations have at least one financial expert on the audit committee, and that firms with greater representation of outside positions and larger boards significantly include more outsiders with financial reporting and audit committee knowledge expertise (Beasley and Salterio, 2001). This is supported by DeZoort *et al*. (2003) who found that more experienced and certified public accountant audit committees show more support to the auditors in the evaluation of auditors' materiality justification and the precision of accounting issues.

The Australian Securities Exchange (ASX) Corporate Governance Council (2003), states that the audit committee should include members who are financially literate (able to read and understand financial statements); at least one member should have relevant qualifications and experience (a qualified accountant or other finance professional with experience of financial and accounting matters) and some members should have an understanding of the industry in which the entity operates. Whereas, the New Zealand Stock Exchange (NZX) (NZX, 2009) clarified that a member of the audit committee will be deemed to have adequate accounting or financial background if he or she:

a. Is a member of the Institute of Chartered Accountants of New Zealand, or has held a Chief Financial Officer (CFO) position at an issuer for a period greater than 24 months; or,
b. Has successfully completed a course approved by NZX for audit committee membership; or,
c. Has experience and or qualification deemed satisfactory by the Board.

KPMG defines financial expert as possessing accounting or other finance qualifications, together with experience in financial accounting matters. From a survey carried out by KPMG (KPMG, 2006), four responses of the desirable kinds of experience and background for audit committee membership were highlighted – (1) experience as a CFO or in another senior accounting or finance role, (2) broad business experience, (3) prior experience as a company director, and (4) has relevant industry experience.

The American Institute of Certified Public Accountants (AICPA) considers the following attributes to be the essential components of financial expertise such as, experience preparing, auditing, analysing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that can reasonably be expected to be raised by the organisation's financial statements, or experience actively supervising (directly involve with) one or more persons engaged in such activities (AICPA, 2005). Hence, issue of financial expert among audit committee members, is highlighted in most literature, from BRC (1999), SOA (2002), DeZoort *et al*. (2003), AICPA (2005), and KPMG (2006).

2.3 Exploring the Audit Committee Experts Dimension

Financial expert among audit committee members is important, but the role of audit committee itself is important in the organisation as they hold functional duties overseeing the financial reporting process, to enhance the firm's governance. Audit committees are one of the main corporate governance mechanisms by which stakeholders hope to constrain the behaviour of corporate managers (Gendron and Bedard, 2006). The extent and quality of monitoring by the board of directors, audit committees, auditors, institutional investors, and financial analysts can have a significant impact on the probability of prevention and detection of financial statement

fraud (Razaee, 2005). Thus, the role of audit committees as one of the monitoring mechanism is important, as it is documented to reduce the practice of income smoothing (Lai and Tam, 2007), provide better financial reporting quality (Jaggi and Leung, 2007), and has a negative association with earnings management (Klein, 2002b). Therefore, the audit committee is an important attribute to reporting validity (Anderson *et al*., 2004). Furthermore, the presence of experts may sharpen and shift the focus of audit committee discussions and overall evaluations of companies' financial reporting quality (McDaniel *et al*., 2002). Most literature focuses on financial experts and defines experts in relation to financial expert. Table 2.1 summarises prior research on audit committees related to financial experts, and shows how audit committee experts are defined.

Table 2.1 Definitions of Audit Committee Experts

Author	Definition of audit committee experts
Defond *et al*. (2005)	(a) Accounting financial expert as per SEC proposal, (b) A non-accounting financial expert, such as company presidents, CEOs, based on the inferences from the final version of SOA.
KPMG (2006)	Possessing accounting or other finance qualifications, together with experience in financial accounting matters.
Zhang *et al*. (2007)	(a) An accounting financial expert who has experience as a public accountant, auditor, principal or chief financial officer, controller, or principal or chief accounting officer, or, (b) A non-accounting financial expert who has experience as the chief executive officer, president, or chairman of the board in a for-profit corporation, or who has experience as the managing director, partner or principal in venture financing, investment banking, or money management.
Mangena and Tauringana (2008)	Members with accounting or financial management experience.
Krishnan and Visvanathan (2008)	(a) Accounting financial experts, (a) Non-accounting financial experts, (b) Non-financial experts (directors who are neither accounting nor non-accounting financial experts).
Goh (2009)	(a) Accounting financial expertise, (b) Non-accounting financial expertise.
Engel, Hayes and Wang (2010)	(a) Non-financial directors are audit committee members with no direct financial training or experience, (b) Finance financial expert are audit committee members with accounting training and experience, including CFOs, vice-presidents of finance, and finance professors, (c) General accounting financial expert are audit committee members with accounting training and experience, (d) Accounting experts with Big4 accounting firms, are those who had employment experience as Big4 accountants.

Sources : Compiled by the author.

Basically, from the studies above, there are two categories of experts – the accounting experts, and non-accounting experts. Accounting experts are those with professional accounting certification or affiliation. While, the non-accounting experts are directors without any certification but have mostly served in senior managerial positions such as CFO or CEO.

The need to have accounting experts or financial experts on the audit committee is clearly stated in SOA 2002, BRC 1999 and also the Code of Corporate Governance. In addition, according to a KPMG ACI 2004 survey (KPMG, 2004), 70.5 percent believe that the losses incurred in some of the high profile financial reporting scandals of the last few years could have been avoided or reduced if financial reporting and audit processes of the companies had been overseen by audit committees that are deemed to be effective by today's standards. Felo *et al*. (2003) suggest that having more than one expert in accounting and financial management on the audit committee may be beneficial to firms.

Prior literature such as the BRC (1999), SOA (2002) and SEC (2003), outlined the criteria for a person to be recognised as a financial expert (see Table 2.2). Consequently, most literature looks at the qualification of the audit committee, as well as the experience. When the items listed earlier are grouped, two common criteria or guidelines are developed based from the expertise paradigm literature; (1) working experience, and (2) qualifications. Therefore, based on the literature, audit committee experts are identified through their work experience, and qualifications. Subsequently, supported by expertise literature, these guidelines will be used for the variables of interest.

Table 2.2 Financial Experts from Prior Literature

BRC (1999)	SOA (2002)	SEC (2003)	Smith Report (2003)	Redington (2006)
a) significant previous working experience in finance and accounting; b) requisite professional certification in accounting; c) comparable experience or background which results in the individual's financial sophistication, including having been working as a CEO or other senior officer with financial oversight responsibilities.	a) through education and experience as a public accountant or auditor or principal financial officer, comptroller, or principal accounting officer of a listed company, or from a position involving similar functions; b) understanding of generally accepted accounting principles and financial statements; c) experience in preparation or auditing of financial statements of generally comparable issuers and the application of such principles in connection with the accounting for estimates, accruals, and reserves; d) experience with internal accounting controls; and e) an understanding of audit committee functions.	a) education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions; b) experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions; c) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or d) other relevant experience.	a) a professional accounting expertise combined with recent relevant experience.	a) an understanding of financial statements and generally accepted accounting principles; b) an ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; c) experience in preparing, auditing, analysing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities; d) an understanding of internal controls and procedures for financial reporting; e) an understanding of audit committee functions.

Sources: Compiled by the author from BRC (1999), SOA (2002), SEC (2003), Smith Report (2003), and Redington (2006). *Note*: **BRC**=Blue Ribbon Committee; **SOA**=Sarbanes Oxley Act; **SEC**=Securities Exchange Commission.

2.4 The Accounting and Non Accounting Financial Expert

2.4.1 Studies in Developed Countries

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). Over the years, audit committees have faced new challenges in their role and responsibilities. Consequently, in the United States (US), the audit committee position is now firmly embedded in legislation and Securities Exchange Commission (SEC) regulations, as well as federal and state government codes of practice (Pickett, 2004).

Many prior studies in audit committee experts are overwhelmed by studies performed in developed countries such as US, UK and Australia (such as Engel *et al*., 2010; Baxter and Cotter, 2009; Krishnan and Visvanathan, 2009; Goh, 2009; Zhang *et al*., 2007; Carcello *et al*., 2006; Defond *et al.*, 2005). The measurement or definition of financial expert from these studies were almost similar, because the measurement or definition relied very much from the SEC Rules (SEC, 2003) and SOA; such as Defond *et al*. (2005), Carcello *et al*. (2006), Qin (2006), and Zhang *et al*. (2007).

Under Section 407 of the Sarbanes Oxley Act 2002, "financial expert" has been defined as a person who has, through education and experience as a public accountant or auditor or principal financial officer, comptroller, or principal accounting officer of a listed company, or from a position involving similar functions. The functions are namely (1) an understanding of generally accepted accounting principles and financial statements; (2) experience in preparation or auditing of financial statements of generally comparable issuers and the application of such principles in connection with the

accounting for estimates, accruals, and reserves; (3) experience with internal accounting controls; and (4) an understanding of audit committee functions.

There was a debate on the term “financial expert” before the SEC came up with the final rule, where “financial” may not completely capture the attributes referenced in Section 407 of the Sarbanes Oxley Act 2002. The provisions focused on accounting and auditing expertise. However, the traditional “financial” matters extend to capital structure, valuation, cash flows, risk analysis and capital-raising techniques. The SEC Final Rule (SEC, 2003) decided to use the term “audit committee financial expert” as the term suggests more pointedly that the designated person has characteristics that are particularly relevant to the functions of the audit committee. It also added that the functions of the audit committee include a thorough understanding of the audit committee’s oversight role, expertise in accounting matters, understanding in financial statements, and the ability to ask the right questions to determine whether the company’s financial statements are complete and accurate.

Under Recommendation 3 of the BRC 1999, the audit committee should comprise minimum three directors, each of whom is financially literate or becomes financially literate within a reasonable period of time after his or her appointment to the audit committee and, further, that at least one member of the audit committee has accounting or related financial management expertise.

According to the BRC, “expertise” signifies past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background that results in the individual’s financial sophistication, including being or having been a CEO or other senior officer with financial oversight

responsibilities. Whereas "literacy" signifies the ability to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement. Since our argument lies in the "expertise" context, we extract the attributes or characteristics that the BRC has given for financial expert.

On the other hand, in contrast to BRC, all members of the audit committee must have the ability to ask probing questions about the corporation's financial risks and accounting. However, the ability to ask and intelligently evaluate the answers to such questions may not require a person to be a financial expert, but it hinges more on the personal intelligence, diligence of a probing mind, together with a certain basic financial literacy as was mentioned above.

In the UK, the Smith Report (2003) on Audit Committees Combined Code Guidance, briefly explains the skills, experience and training of the audit committees. This includes having at least one member that should have a significant, recent and relevant financial experience, for example, as an auditor or a finance director of a listed company. Also, that it is highly desirable for this member to have a professional qualification from one of the professional accountancy bodies. However, the report did not explain in detail the meaning of "financial expertise", but raised a degree of financial literacy in other members that will vary according to the nature of the company and requires the experience of corporate financial matters.

The requirement of financial expertise alleviates worries concerning the potential of the audit committee to understand generally accepted accounting principles and experience in preparing audit level financial statements as well as dealing with internal accounting controls (Matthews, 2005). Various attributes of the board and audit committee may

influence their effectiveness as corporate governance mechanisms (Cohen *et al*., 2004). This is supported by Vera-Munoz (2005) in examining the redefined expectations of corporate audit committee responsibilities and effectiveness in the wake of corporate governance reforms. She documents that the audit committee role as the ultimate monitor of the financial reporting process, must be informed, vigilant and be an effective overseer of the financial reporting process. Coates *et al*. (2007) show that board members have begun to improve their financial literacy, and that companies who have improved their potential for financial literacy have superior stock market returns. Furthermore, companies that improved their boards' financial literacy have annualised abnormal excess returns of 4.6 percent per year more than those who did not improve.

Qin (2006) examined the impact of the audit committee's financial expertise on earnings quality, as measured by return-earnings relation, and how it varied with the way the "financial expert" is defined. It was found that firms with an accounting literate professional serving on the audit committee, as the SEC initially proposed, are more likely to have a high quality of reported earnings than those without such an expert. Furthermore, size of audit committee with accounting related expertise has a positive impact on earnings quality. However, contrary to the SEC final rule, the study suggests that only accounting literate professionals, as the SEC initially proposed, are related to a good quality of reported earnings. In addition, Raghunandan and Rama (2007) found a significant positive relationship between the proportion of accounting experts and the number of meetings. Consistent with Aier *et al*. (2005) who found that companies that have CFOs with CPA, an MBA, or more experienced CFOs, are less likely to restate earnings.

Defond *et al*. (2005) examined the market reaction to appointing financial experts (as defined by Sarbanes Oxley Act), and document that there is a significant and positive market reaction to the announcement of new directors with accounting financial expertise. In addition to the issue of accounting and non-accounting financial expert, as argued in Defond *et al*. (2005), Krishnan and Visvanathan (2009) look into three different definitions of experts: accounting financial experts, non-accounting financial experts and neither accounting nor non-accounting financial experts. Results support the market reaction in Defond *et al*. (2005) where accounting expertise contributes to greater monitoring by the members of the audit committee, which, in turn, enhances multiple attributes of financial reporting quality. A recent study by Mustafa and Youssef (2010), shows the effectiveness of audit committee in reducing misappropriation of assets, provided if the audit committee is a financial expert. Hence, suggests that financial experts have their roles in improving financial reporting quality. Hence supports earlier study by Krishnan and Visvanathan (2009) that show the accounting expertise of audit committee members, contributes to greater monitoring by the members, thus, lowering the control risk for the auditor.

In DeZoort and Salterio (2001), 68 audit committee members completed an accounting policy dispute case and several knowledge and ability tests. They investigated whether there were systematic differences in support of the auditor among audit committee members with varying degrees of independence and financial knowledge. It was found that there is no relationship between financial reporting knowledge and audit committee member judgement. However, more independent board members with experience and higher audit reporting knowledge are associated with greater support for the auditor in disputes with client management. Furthermore, in Read and Raghunandan (2001) they found that 60 percent of the independent audit committees with expertise in accounting

and finance reviewed internal audit proposals, and a majority of 65 percent of independent, financially sophisticated audit committees reviewed internal audit results and management's responses to them. Therefore, suggesting that independent and qualified audit committees may be more willing and able to investigate accounting irregularities, exceptions or other relevant matters, such as scope restrictions that management impose.

Table 2.3 shows prior studies related to audit committees among developed countries such as US, UK and Australia. There seems to be constant change of measurement on audit committee financial expertise, in tandem with regulatory changes, such as when BRC was introduced in 1999, post BRC studies adopted BRC's recommendation. For example, Raghunandan *et al*. (2001) and Beasley and Salterio (2001) that adopted BRC's recommendation - audit committee members with expertise in accounting or related financial expertise. Subsequently, when SOA was introduced in 2002, studies post SOA adopted the newly definition of audit committee financial expertise and more liberal definition of SEC final rules (2003), such as, Defond *et al*. (2005), Zhang *et al*. (2007), Krishnan and Visvanathan (2009), Krishnan and Lee (2009), Goh (2009) and Mustafa and Youssef (2010).

Table 2.3 Studies on Audit Committee Experts among Developed Countries

Author(s) (Country in sample)	Research Objectives	Findings	Measurement and Types of Expertise and Financial Literacy
Engel *et al.* (2010) (US)	To investigate audit committee compensation and demand for monitoring financial reporting process.	Willingness of firms in light of the increase in demand on audit committee and differential directors' expertise.	(a) Non-financial directors are audit committee members with no direct financial training or experience, (b) Finance financial expert are audit committee members with accounting training and experience, including CFOs, vice-presidents of finance, and finance professors, (c) General accounting financial expert are audit committee members with accounting training and experience, (d) Accounting experts with Big4 accounting firms, are those who had employment experience as Big4 accountants.
Mustafa and Youssef (2010) (US)	To investigate the relationship between audit committee expertise and incidence of misappropriation of assets.	Audit committee member is only effective in reducing the occurrence of misappropriation of assets, if he/she is also a financial experts.	(a) Accounting financial expert who has experience as public accountant, auditor, principal or CFO, controller, or principal or chief accounting officer, (b) Non-accounting financial expert who has experience as CEO, president, or chairman of the board, or experience as managing director, partner or principal in venture financing, investment banking, or money management.
Baxter and Cotter (2009) (Australia)	To examine audit committee association with improved earnings quality.	Higher earnings quality firms have greater proportion of qualified accountants on audit committee.	(a) Audit committees with accounting qualifications, (b) Audit committees with legal qualifications.

Author(s) (Country in sample)	Research Objectives	Findings	Measurement and Types of Expertise and Financial Literacy
Krishnan and Visvanathan (2009) (US)	To examine audit fees and audit committee financial expert.	Audit fee is negatively correlated with accounting financial expertise.	(a) Accounting financial experts are directors, (b) Non-accounting financial experts are directors with experience as CFOs or president of the companies.
Goh (2009) (US)	To examine if audit committees and board of directors, play an important role in internal control deficiencies.	Proportion of audit committee members with financial expertise is positively associated with firms' timeliness in the material weaknesses remediation.	(a) Accounting financial expertise, where expertise gained from accounting-related experience in SEC reporting, (b) Non-accounting financial expertise, where expertise gained from experience supervising employees with financial responsibilities and overseeing the companies' performance.
Krishnan and Lee (2009) (US)	To examine the determinants of firms' choice of audit committee financial experts.	Firms with higher litigation risk are more likely to have audit committees financial experts.	(a) Accounting financial experts, who has held and currently holds a job directly related to accounting and auditing expertise. (b) Non-accounting financial experts, who has held and currently hold positions such as managing directors, or accounting or finance professors, CEOs and presidents of companies.
Mangena and Tauringana (2008) (UK)	To investigate the relationship between audit committee characteristics and the decision to engage external auditors to review published interim reports.	The likelihood of engaging an external auditor to review interim reports increases with audit committee independence and financial expertise.	Audit committee members with accounting or financial management experience.

Author(s) (Country in sample)	Research Objectives	Findings	Measurement and Types of Expertise and Financial Literacy
Krishnan and Visvanathan (2008) (US)	To examine the association between audit committee's accounting financial expertise and non-accounting financial expertise with financial reporting quality.	Accounting financial expertise are able to effectively perform their monitoring function and promote conservative accounting only when there are boards that are characterised by strong governance.	(a) Accounting financial experts, (b) Non-accounting financial experts, (c) Non-financial experts (directors who are neither accounting nor non-accounting financial experts).
Raghunandan and Rama (2007) (US)	To examine the association between firm characteristics and the number of audit committee meetings as proxy for audit committee diligence.	There is significant positive relationship between the proportion of accounting experts and the number of meetings, but no association between the proportion of non-accounting financial experts and the number of meetings.	(a) Accounting experts, are directors with experience as public accountant or auditor or principal financial officer, controller, or principal accounting officer, (b) Other experts, are non-accounting expert.
Zhang *et al*. (2007) (US)	To investigate the relation between audit committee quality, auditor independence, and the disclosure of internal control weaknesses after SOA.	Firms with less financial expertise in their audit committees, are likely to be identified with internal control weaknesses.	(c) Accounting financial expert who has experience as public accountant, auditor, principal or CFO, controller, or principal or chief accounting officer, (d) Non-accounting financial expert who has experience as CEO, president, or chairman of the board, or experience as managing director, partner or principal in venture financing, investment banking, or money management.
Qin (2006) (US)	To examine the impact of audit committee's financial expertise on earnings quality.	Firms with accounting literate professional as SEC proposed serving on the audit committee, are more likely to have quality of reported earnings than others without such expert.	(a) Experts with previous positions such as CPAs, auditor, principal or CFO, controller, or chief accounting officer, (b) Presidents, CEOs, professional financial analysts, investment bankers and venture capitalists.

Author(s) (Country in sample)	Research Objectives	Findings	Measurement and Types of Expertise and Financial Literacy
Carcello *et al*. (2006) (US)	To examine disclosure of whether the audit committee has financial expert.	Most audit committee financial experts do not have background in accounting or finance.	SEC Rule (SEC, 2003)
Defond *et al*. (2005) (US)	To examine cumulative abnormal returns around announcements of appointed outside directors assigned to audit committees during a period before implementation of SOA.	Positive market reaction to the appointments of accounting. But no reaction to non-accounting financial experts assigned audit committees.	(a) Accounting financial expert, where all directors with experience as CPAs, auditor, CFO, controller, or principal or chief accounting officer, (b) Non-accounting financial expert, where all directors with experience as CEO or president, (c) Non-financial expert, where all directors who do not meet the definition of SOA financial expert.
Aier *et al*. (2005) (US)	To investigate whether the characteristics of CFOs are associated with accounting errors (using accounting restatements as a proxy).	Companies who CFOs have more work experience as CFOs, MBAs, and or, CPAs, are significantly less likely to restate earnings.	Nil.
Raghunandan *et al*. (2001)	To examine the association between audit committee composition and the committee's interaction with internal auditing.	Audit committees comprised solely of independent directors and with at least one membr having an accounting or finance background are more likely to have longer meetings with the chief internal auditor, provide private access to the chief internal auditor, and review internal audit proposals and results of auditing.	Audit committee members with accounting and finance background as mentioned in BRC.

Author(s) (Country in sample)	Research Objectives	Findings	Measurement and Types of Expertise and Financial Literacy
Beasley and Salterio (2001) (Canada)	To examine the relation between board characteristics and audit committee composition voluntarily exceeds mandated levels, including outside directors with financial reporting and audit committee knowledge and experience.	Firms that voluntarily include more outside directors on the audit committee than the mandated minimum level, have larger boards with more outsider serving on those boards, and are more likely to segregate the board chairpersonposition firm CEO/president position.	Audit committee members with relevant financial reporting audit committee knowledge and experience, as suggested in BRC.
Raghunandan *et al*. (1998)	To examine knowledge level of audit committee.	Audit committee that gave private access to CIA and reviewed program results of internal audit, are more likely to be perceived as knowledgeable about accounting and auditing issues.	CIA perceptions about knowledge level of their audit committee members.

Sources : Compiled by the author.

2.4.2 Studies in Emerging Economies Country

Table 2.4 shows studies on audit committee experts on emerging economies. The empirical investigations in emerging economies such as Malaysia and China, shows evidence that the definition or measurement of financial experts are still tentative. Furthermore, in China, corporate governance was still far behind from the developed nations such as US, UK and other western countries (Lin *et al*., 2008). In addition, most of the Malaysian studies such as Rahmat *et al*. (2009), Ismail *et al*. (2008), Yatim *et al*. (2006) and Iskandar and Abdullah (2004), measured financial expertise as being a MIA membership (Ismail *et al*., 2008; Rahman and Ali, 2006). Or vaguely acknowledged the financial literacy background of the audit committee member such as Rahmat *et al*. (2009) where they only mentioned audit committee experts, are those with knowledge in accounting and finance, and with relevant years of experience in practice. Or merely audit committee members with accounting and finance qualifications such as in Saleh *et al*. (2007), Yatim *et al*. (2006) and Iskandar and Abdullah (2004).

In addition, Singapore and Hong Kong, are almost in similar situation to Malaysia and China. Whereby, the Singapore Exchange (SGX, 2009, pD-4) interprets '*expert*', as "including engineer, valuer, accountant, financial adviser or any other person whose profession or reputation gives authority to a statement made by him, which is similar for the interpretation of the Hong Kong Exchange and Clearing Ltd" (HKEx, 2009, Chapter 1 p7).

Table 2.4 Studies on Audit Committee Experts among Emerging Economies Countries

Author(s)	Research Objectives	Findings	Measurement of Expertise and Financial Literacy
Rahmat *et al*. (2009) (Malaysia)	To investigate difference between distressed and non-distressed companies.	Financial literacy of audit committee members is a significant factor that helps audit committee to improve companies' financial performance.	Financial literate audit committee members are those with knowledge in accounting and finance, with relevant years of experience in practice.
Lin *et al*. (2008) (China)	To investigate the perceptions of the roles, responsibilities and basic characteristics of audit committee in China.	In general, the standards and practices of corporate governance in Chinese limited companies are far behind developed countries. The ineffectiveness of audit committee operations may be associated with poor qualifications of their members. Most audit committee members lack management expertise and practical experience of corporate financial reporting and auditing process.	CSRC (2001, para52), mentioned that at least one member of the audit committee shall be an accounting professional.
Ismail *et al*. (2008) (Malaysia)	To examine the relationship between companies quality reporting and elements of corporate governance, such as external audit and audit committee.	No relationship between financial literacy, frequency of meetings and audit committee's independence, with quality of reporting.	MIA membership as defined in the Accountants Act 1967 as proxy for financial literacy.
Saleh *et al*. (2007) (Malaysia)	To examine the audit committee effectiveness, in monitoring management behaviour with respect to their incentives to manage earnings.	Firms with more knowledgeable audit committee members, and held more audit committee meetings, recorded fewer earnings management.	Audit committee members who are members of professional accounting body.

Author(s)	Research Objectives	Findings	Measurement of Expertise and Financial Literacy
Bliss *et al*. (2007) (Malaysia)	To examine the relationship between firm's internal corporate governance characteristics and audit fees.	Presence of CEO duality on the board of director, is associated with higher audit fees. But this relationship is weakened when firms have higher proportion of independent directors on audit committees.	Nil.
Muniandy (2007) (Malaysia)	To investigate the impact that effective audit committee have on the assessed inherent risk perceived by external auditor as manifested in the audit fee charged, in the presence of CEO duality.	Presence of CEO duality is associated with higher audit fees, but weakened when the firms have higher proportion of independent directors on audit committee.	Nil.
Rahman and Ali (2006) (Malaysia)	To investigate the extent of the effectiveness of monitoring functions of board of directors, audit committee and concentrated ownership in reducing earnings management.	Board size is positively related to earnings management, implying that smaller board size could mean that directors are more focused in solving arising issues.	Measure competence or qualified, when audit committee member is a registered MIA member, or a qualified accountant.
Yatim *et al*. (2006) (Malaysia)	To examine the association between external audit fees, and board and audit committee characteristics.	External audit fees are positively and significantly related to board independence, audit committee expertise, and the frequency of audit committee meetings.	Audit committee members with accounting and finance qualifications.
Iskandar and Abdullah (2004) (Malaysia)	To examine the relationship between selection of external auditors with audit committee variables.	Financial literacy of audit committee members fails to show any association with the selection of external auditor.	Audit committee members with accounting qualification.

Sources : Compiled by the author.

Audit committees only emerged in Malaysia in the mid 1980s, following the collapse of a merchant bank in Malaysia (Abdullah, 2007), previously known as Bank Bumiputra Malaysia Berhad. In 1993, listed companies were required to have an audit committee and were given a one-year grace period to implement it. Later, in 1994, Bursa Malaysia had mandated that all listed companies maintain audit committees, comprising a majority of non-executive directors. However, in Malaysia audit committees are bound by the Bursa Malaysia Listing Requirements, hereafter, as Listing Requirements, the Malaysian Code on Corporate Governance (MCCG), and the Securities Commission (SC). Haron *et al*. (2005) investigated the extent of companies' compliance with the Listing Requirements in relation to audit committees and documented that 45 percent of the sample complied with the listing requirements, suggesting that enforcement is needed to improve the compliance level.

The BMSB Listing sets out in Chapter 15, Part C on Audit Committee, para 15.10 the Composition of the Audit Committee. It is required by the listed issuer to appoint an audit committee from among its directors that fulfils the following requirements (BMSB, 2009):

b) the audit committee must consist of not less than three members;

c) a majority of the audit committee must be independent directors; and

d) at least one member of the audit committee

   I. must be a member of the MIA; or

   II. if the person is not a member of the MIA, the person must have at least three years' working experience and;

e) the person must have passed the examinations specified in Part I of the 1st Schedule of the Accountants Act 1967; or

f) a member of one of the associations of accountants specified in Part II of the 1st Schedule of the Accountants Act 1967.

The BM listing requirements for an audit committee member were more specific than the ASX and NZX, as he or she must have passed certain examinations as an accountant. Singaporean corporate governance also provides guidelines for choosing the audit committee. The Singaporean Corporate Governance Committee (2001) states that the board should ensure that members of the audit committee are appropriately qualified to discharge their responsibilities; and that at least two members should have accounting or related financial management expertise or experience, as the Board interprets such qualification in its business judgement.

Even though the required composition of audit committees for ASX, NZX, HKEx, US, UK and Malaysia, are almost similar (see Table 2.5 below), but the literature is inadequate in suggesting the appropriate measurement of *experts* as was discussed in section 2.3. The interpretation of 'expert' by SGX and HKEx, are rather vague, and hence need to be further improved so that corporations and stakeholders have some knowledge in suggesting or finding potential experts for their firms. Hence, even among the emerging economies like Singapore, Hong Kong and Malaysia, there is still a need to find an appropriate measure that is suitable for countries of such economic background.

Table 2.5 Audit Committees from Legislators' Literature

Bursa (2009)	ASX (2007)	NZX (2009)	HKEx (2010)	SMITH REPORT (2003)	BRC (1999)
1. Minimum 3 members. 2. Majority are independent directors. 3. At least one with accounting background. 4. All must be non-executive directors.	1. Minimum 3 members. 2. Majority are independent directors. 3. Non-executive directors only. 4. Chaired by independent directors, and not chairman of the board.	1. Minimum 3 members. 2. Majority independent directors. 3. Consist of only directors of the issuer. 4. At least one with accounting or finance background.	1. Minimum 3 members. 2. Majority must be independent non-executive directors. 3. Non-executive directors only. 4. At least one is independent, non-executive director, with accounting or financial background. 5. Chaired by independent non-executive director.	1. Minimum 3 members. 2. Independent non-executive directors only. 3. At least one with financial background. 4. Chairman of company should not be member.	1. Minimum 3 members. 2. Each member is financially literate. 3. At least one with accounting and financial background. 4. Only independent directors.

Sources : Compiled by the author. *Note*: **Bursa**=Bursa Malaysia; **ASX**=Australian Securities Exchange; **NZX**=New Zealand Exchange; **HKEx**=Hong Kong Exchange and Clearing Ltd; **BRC**=Blue Ribbon Committee.

2.5 Financial Reporting Quality

Prior literature among emerging economies such as Malaysia and China in section 2.4.2, shows relevant studies on audit committees in relation to financial reporting quality, proxied by earnings management (see Saleh *et al.*, 2007 and Rahman and Ali, 2006). Subsequently, measures of audit committee experts that used are almost similar, such as Lin *et al*. (2008), Saleh *et al*. (2007) and Rahman and Ali (2006), where measure of expertise are merely ‘as members of accounting professional body’. However, studies pertaining financial reporting quality and audit committee experts are very limited among these countries, especially on other proxies or indicators of financial reporting quality.

There are three indicators of financial reporting quality; earnings management, restatements, and fraudulent financial reporting as mentioned by Cohen *et al*. (2007). In Zhao and Chen (2008), they employed proxies for earnings management by using financial reporting fraud, which is similar to Beasley (1996) and Erickson *et al*. (2006), and consistent with the definition by POB (2000), “where fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements that might be considered as part of a scheme to ‘manage earnings’” (POB, 2000, p75). Consequently, fraudulent financial reporting and earnings management are about the reliability of financial statements that relate to the issue of truthfulness of the quality of earnings disclosed (Akers *et al.*, 2007). Whereby, earnings quality is a measure of the ability of reported earnings to reflect the firm’s true earnings and to help predict future earnings (Balsam *et al.*, 2003).

2.5.1 Fraudulent Financial Reporting

It is important to distinguish between error and fraud. Error is an unintentional mistake in financial statements. However, fraud is said to occur with intention in order to conceal or benefit certain parties. The International Standards of Auditing (ISA) refers "fraud as an intentional act by one or more individuals among management, employees, or third parties, which results in a misrepresentation of financial statements" (MIA Malaysian Approved Standards of Auditing, 2005, p28)[6]. In addition to that definition, there is also occupational fraud and abuse that actually involves a wide variety of conduct by executives, employees, managers, and principals of organisations, ranging from sophisticated investment swindles to petty theft (Wells, 2005). Wells added that the common violations include asset misappropriation, fraudulent statements, corruption, pilferage and petty theft, false overtime, using company property for personal benefit, and payroll and sick time abuses. Thus, Wells classified occupational fraud and abuse into three categories – corruption, asset misappropriation and fraudulent statements. Subsequently, fraud for or against a company can take the form of fraudulent financial reporting, which is also known as management fraud and misappropriation of assets, or employee fraud known as defalcation (Krambia-Kapardia, 2002). According to POB (2000), two types of intentional misstatements are relevant to fraud – misstatements from fraudulent financial reporting and misstatements from misappropriation of assets. Whereas, misappropriation of assets involves theft of the entity's assets and is accompanied by financial statement misrepresentation (POB, 2000).

[6] International Standards on Auditing (ISA) are to be applied in the audit of financial statements under all reporting frameworks. Reporting frameworks are determined by legislation, regulations and promulgation of the Malaysian Institute of Accountants (MIA) and where appropriate mutually agreed upon terms of reporting. ISA are also to be applied, adapted as necessary, to the audit of other information and to related services.

Loebbecke *et al*. (1989) highlighted the potential for audit committees and board of directors' governance mechanisms to reduce occurrences of financial statement fraud. It was observed that where controls over top management are weak, a significant condition may exist that could allow fraudulent financial reporting to occur. Hence, in Beasley (1996), examines the relation between board of directors' composition and the occurrence of financial statement fraud, and document that certain characteristics of individuals who serve as outside directors on no fraud firms boards also helps reduce the likelihood of financial statement fraud. Whereby, prior experience as directors and incentives for monitoring management are likely to affect their performance on a particular board of directors. This is supported by Dechow *et al*. (1996) and McMullen (1996) that document an association between weaknesses in certain audit committee and board of directors' governance mechanisms, and fraudulent financial reporting. In addition, Beasley *et al*. (2000), when comparing company governance mechanisms to no fraud industry benchmarks, fraud and no fraud firms differ in several audit committee dimensions including the technology industry and financial services, which are less likely to have an audit committee. Furthermore, the audit committees in the fraud firms are less independent and have a lower percentage of outside directors. This is supported by a recent study that documents the likelihood of fraudulent financial reporting is negatively related to audit committee independence (Krishnan and Visvanathan, 2009).

On the other hand, fraud is also considered as irregularities. Krambia-Kapardis (2002) defines fraud as an act that involves the use of deception to obtain illegal advantage. Furthermore, Kapardis added that fraud, which resulted in a materially misstated financial report, is of particular interest to auditors as they have a legal responsibility for detecting and reporting such irregularities. Loebbecke *et al*. (1989) explain that

irregularities are difficult to detect because they are generally subject to concealment related to accounting records and related documentations. In Loebbecke's study, 55.4 percent of the respondents who encountered irregularities claim that it was from management fraud, and 80 percent of that figure relates to financial statements. Thus, to ensure that figures in the financial statements have been prepared according to the standards, independent auditors are hired by management to provide 'assurance' to shareholders and other interested parties that the reports fairly represent the results of operations and the position of the companies (Millar and Yeager, 2007). Errors in financial reporting are considered as a conflict with accounting and affect the quality of financial reporting. Firth *et al*. (2005) found that a high occurrence of material misstatement of fraud and revenue related fraud is associated with a higher possibility of enforcement actions against auditors rather than disclosure fraud and asset related fraud. Firms with a higher potential litigation risk are more likely to appoint accounting financial experts to their audit committees, as documented in Krishnan and Lee (2009).

2.5.2 Restatements

On the other hand, restatement is sometimes intertwined with fraud. Restatement and fraud often reflect similar financial reporting conditions, i.e. materially misstated financial statements that have been issued to investors as in Abbott *et al*. (2004). Similarly, consistent with the findings by Palmrose and Scholz (2004), it shows that companies with core restatements have higher frequencies for intentional misstatement or fraud. Financial restatement is an important feature in the corporate landscape as it represents a unique opportunity to study the accountability of leaders for organisational outcomes and independence of firm's performance (Arthaud-day *et al*., 2006).

Research has found that restatements are a significant event for a public company as noted by Richardson (2005), and reflect low quality financial reporting (Kinney *et al*., 2004). In addition, restatements are also reported to have an association between CFO characteristics and the occurrence of accounting restatements. Where, companies that have CFOs with CPA certification, an MBA or more experience as CFOs, are less likely to restate earnings (Aier *et al*., 2005). Aier posits that CFO oversees the implementation of accounting principles and procedures, and the preparation of financial reporting. They are responsible for establishing and maintaining internal control and reporting any deficiencies to the audit committee and external auditor. Consequently, Arthaud-day *et al*. (2006) show that leaders suffered personal losses following restatement events. It is reported that CEOs, CFOs, outside directors and audit committee members in firms that announced a restatement were more likely to subsequently lose their jobs than their counterparts in a sample of control firms. Hence, supports earlier study by Srinivasan (2005), which found outside directors (in particular, outside members of audit committees) are more likely to leave the board of a company that completes a restatement and to subsequently lose directorship in other companies. In addition, Abbott *et al*. (2004) investigated firms with audit committees, that are consistent with the BRC recommendations are less likely to experience restatements.

2.5.3 Earnings Management

Earnings management occurs, as Healy and Wahlen (1999) mentioned, when managers use judgement in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers. Their definition itself frames the objective of earnings management as being to mislead stakeholders about the underlying economic

performance of the firm. Verdi (2006) defines earnings management as the accuracy with which financial reporting conveys information about the firm's operations to inform investors in terms of equity investment decisions, in particular, its expected cash flows. Hence, the accounting earnings reflect the real economic performance of a firm in a lagged fashion due to accounting conservatism, verifiability, and other conventions (Qin, 2006). Earnings management also involves the selection of accounting procedures and estimates that conform to generally accepted accounting principles (GAAP) (Rahman and Ali, 2006), and estimates that result in reported earnings that are advantageous to the companies or its managers at the expense of external stakeholders (Krishnan and Parsons, 2008). In addition, standard setters view the quality of financial reports as an indicator of the quality of financial reporting standards (Schipper and Vincent, 2003).

Earnings management, generally, implies activities undertaken that are designed to either smooth earnings over two or more interim or annual accounting periods, or to achieve a designated earnings level (POB, 2003). While Akers *et al*. (2007) noted that earnings management is recognised as attempts by management to influence or manipulate reported earnings by using specific accounting methods, recognising one time non-recurring items, deferring or accelerating expense or revenue transactions, or using other methods designed to influence short term earnings. The opportunistic behaviour by the managers will benefit shareholders if the accounting discretion is used to signal private information about future performance (Peasnell *et al*., 2005), and to reduce political costs that could avoid a costly debt re-contracting (Watts and Zimmerman, 1978). The informativeness of earnings is more prevalent in firms with higher managerial ownership (Warfield *et al*., 1995).

Studies under earnings management that involve corporate governance have been associated with capital markets such as Ball and Shivakumar (2008a, 2008b), board characteristics (Gul *et al*., 2002; Klein, 2002b; Gul *et al*., 2003; Xie *et al*., 2003; Davidson III *et al*., 2004; Baxter and Cotter, 2009; Garcia-Meca and Sanchez-Ballesta, 2009), and external auditors or auditor industry specialists (Krishnan, 2003; Balsam *et al*., 2003; Hodge, 2003; Gul *et al*., 2009). Krishnan (2003) shows that industry specialists are less likely to be associated with accrual-based earnings management, which is supported by Balsam *et al*. (2003) who document that clients of industry specialist auditors have lower discretionary accruals and higher earnings response coefficients than clients of non-specialist auditors.

Prior accounting studies that focus mostly on internal governance mechanisms found that earnings quality is associated with board composition such as Beasley (1996) and Klein (2002b). A study by Jaggi and Leung (2007) examined earnings management and the impact of family dominance in Hong Kong, and thus report a negative association between the voluntary establishment of audit committees and discretionary accruals, a proxy for earnings management. It is noted that the effectiveness of audit committees is weakened when family members are present on the corporate boards.

Bedard *et al*. (2004), Krishnan (2005) and Yang and Krishnan (2005), show evidence of statistical association between audit committee characteristics and earnings management. Bedard *et al*. (2004) document that, the likelihood of aggressive earnings management decreases if the audit committee includes a financial expert, or an expert in corporate governance, and if they are composed entirely of independent directors. Furthermore, Piot and Janin (2007) noted that audit committees stand as valuable audit quality devices, because they constrain the more egregious form of earnings

management – income increasing. On the other hand, Lin *et al*. (2006) study the effect of audit committee performance on earnings quality, and document a negative association between audit committee size and the occurrence of earnings restatement. In addition, Cheng (2008) documented that firms with larger boards have less variable total accruals, abnormal accruals, and extraordinary items; suggesting that firms with larger boards are less likely to manage earnings using accruals and extraordinary items.

Xie *et al*. (2003) show evidence consistent with the BRC, indicating that a lower level of earnings management is associated with greater independent outside representation on the board. Furthermore, earnings management is less likely to occur in companies whose boards include more independent outside directors and directors with corporate experience. This is supported by Peasnell *et al*. (2005) who report that the likelihood of managers making income increasing abnormal accruals to avoid reporting losses and earnings reductions is negatively related to the proportion of outsiders on board. Peasnell *et al* indicate that boards contribute to the integrity of financial statements as predicted by the agency theory. Klein (2002a) examines audit committee and board characteristics association to earnings management using cross-sectional Jones' model, and documents a negative association between board and audit committee independence with abnormal accruals.

Peasnell *et al*. (2006) noted that no business likes to report a loss, or even a downturn in profits, and that it is under such situations that managers may be most tempted to bend the numbers. Hence, published financial statements are a useful measure of business performance and holding senior managers accountable. It is a unique feature of real earnings management is that it involves the manipulation of real business activities such

as, research and development expenditure, capital investments, and the production, sale and disposal of long term assets (Xu *et al*., 2007).

2.6 Financial Reporting Quality and Audit Committee

According to Zhang *et al*. (2007), the audit committee serves as an important governance mechanism because the potential litigation risk and reputation impairment faced by audit committee members ensure that these audit committee members discharge their responsibilities effectively. Other than being one of the governance mechanisms, Carcello and Neal (2000), posit that audit committees play an important role in corporate accountability as well as in ensuring the quality of financial reporting. This is further outlined in the ASX (2003) Principle 4, where it states the purpose of the audit committee; where the board of the audit committee is an efficient mechanism for focusing on issues relevant to the integrity of the company's financial reporting. Further, it mentions the importance of the existence of an independent audit committee member, which is recognised internationally as an important feature of good corporate governance. Davidson *et al*. (2005) note that the specialised monitoring of financial reporting and audit activities provided by the audit committee, act as the greatest protection to shareholders to maintain credibility of a firm's financial statements.

Subsequently, good corporate governance plays an important role in strengthening the integrity and efficiency of financial reporting. In harnessing this agenda within the organisation, good governance needs the intervention and participation from the people or key players. Audit committees, being one of the key players are important as they are composed of non-executive and independent board members. More importantly, they oversee the corporate governance processes, financial reporting, internal control, and audit functions (Rezaee, 2003), and, in the constitution, to review and be satisfied with

the adequacy of a company's financial reporting process (Murali and Ramesh, 2007). It was also highlighted in Anderson *et al*. (2004), when they examined board characteristics, accounting report integrity and cost of debts. The results provide market-based evidence that suggests boards and audit committees are important mechanisms in overseeing the financial accounting process. The inclusion of a higher proportion of independent directors on boards can result in more effective monitoring of boards and exert greater influence on management decisions in relation to the audit committee.

A recent study by Ismail *et al*. (2008) found no significant relationship between financial literacy, frequency of meetings and independence of committee members, with quality of reporting. They measure corporate reporting quality from the companies selected in the NACRA (National Annual Corporate Report Award) for having good financial reporting. An earlier study by Beasley and Salterio (2001) shows that the board of directors have numerous mechanisms to monitor the financial reporting processes of the firm; and the audit committee is the subcommittee of the board of directors that is assigned the primary responsibility for this monitoring.

Abbott *et al*. (2004) document that audit committee expertise and independence are negatively related to fraud, which are consistent with Felo *et al.* (2003) who report evidence suggesting that audit committees have an impact on financial reporting quality. Felo *et al*. (2003) when investigating whether audit committee characteristics impact the quality and credibility of financial reporting found evidence of a positive relationship between the fraction of audit committee members with financial expertise and financial reporting quality.

2.7 The Gap

Prior literature concerning audit committees in relation to financial reporting quality, such as Dechow *et al.* (1996) found a correlation in earnings manipulation and weaknesses in oversight of management because of the lack of an audit committee, absence of large independent shareholders, and the presence of an insider-dominated board. This is supported by Saleh *et al.* (2007) who argue that the existence of a good audit committee is necessary but not sufficient to eliminate earnings management.

Previous studies have shown the significant roles of the board of directors as a body accountable in ensuring good governance (Petra, 2005; Uzun *et al.*, 2004). Subsequently, audit committees act as an important mechanism in the corporate governance (Zhang *et al.*, 2007; Anderson *et al.*, 2004), and have an important role in ensuring the financial reporting quality (Carcello and Neal, 2000). The vast majority of audit committee literature looks into the audit committee effectiveness from various aspects; as a non-executive director or board independence (Chen *et al.*, 2005; Iskandar and Abdullah, 2004; Windram and Song, 2004; Beasley and Salterio, 2001), on responsibilities or functions (Joshi and Wakil, 2004; Gendron *et al.*, 2004; Collier and Gregory, 1999), and being a financial expert or having accounting and finance background (DeZoort and Salterio, 2001; Read and Raghunandan, 2001; Burrowes and Hendriks, 2005; Defond *et al.*, 2005; Qin, 2006; Vermeer *et al.*, 2006; Coates *et al.*, 2007; Mangena and Tauringana, 2008; Baxter and Cotter, 2009; Engel *et al.*, 2010; Mustafa and Youssef, 2010). From the literature, audit committees with financial expertise are important as they show support for auditors (DeZoort and Salterio, 2001; DeZoort *et al.*, 2003), the credibility of the financial statement (Burrowes and Hendriks, 2005), and the high quality of reported earnings (Qin, 2006). Furthermore, having an audit committee financial expert proves that they will review the internal audit

programme (Read and Raghunandan, 2001) and reduces the likelihood of misappropriation of assets in publicly held companies (Mustafa and Youssef, 2010). Subsequently, it has been documented that the market appreciates audit committee financial expertise as studies have shown an excess return of 4.6 percent in Coates *et al*. (2007) and a positive market reaction to the announcement of directors with accounting financial expertise (Defond *et al*., 2005).

However, there have been few 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. Qin (2006) studied audit committee financial experts in relation to earnings quality and, recently, Baxter and Cotter (2009) examined audit committees with earnings management and included two types of expertise, namely, with accounting background and legal background, and Engel *et al*. (2010) examined the relation between audit committee compensation and demand for monitoring of the financial reporting process. Other studies in relation to earnings quality and earnings management (Lai and Tam, 2007; Joshi and Wakil, 2004; Rahman and Ali, 2006; Klein, 2002b; Dechow *et al*., 1996), examined audit committees with corporate governance or in relation to the board of directors, and did not specifically investigate the audit committee financial expertise in depth. Conclusively, most research examined audit committees with financial reporting quality, either looking from the aspect of earnings quality and earnings management, or financial restatements (Abbott *et al*., 2004), but few have examined the financial expertise composition specifically; and none have considered extending the benchmark of considering an expert as being other than a professionally qualified accountant.

The measurement of expertise may need to be further analysed, as SOA and SEC's description may not fit for emerging economy country, such as Malaysia. Malaysian listing requirements' guideline is almost similar with other countries such as Australian, New Zealand, Hong Kong and BRC, but the measurement of financial expertise is not a case of 'one size fits all' scenario. Furthermore, studies in the Malaysian context, such as Iskandar and Abdullah (2004), Rahman and Ali (2006) and Ismail *et al*. (2008) fail to find any association between financial expertise and financial reporting quality. This prompts one to question if a more distinct measure is needed. In addition, focus of expertise may need to be expanded than the existing measurement many studies adopted such as the SEC or SOA's definition (such as Defond *et al*., 2005; Carcello *et al*., 2006), or merely relying on measurement such as MIA membership (Ismail *et al*., 2008; Rahman and Ali, 2006), or only brief description such as Rahmat *et al*. (2009) that mentioned audit committee experts, are those with knowledge in accounting and finance, with relevant years of experience in practice, or audit committee members with accounting and finance qualifications such as in Iskandar and Abdullah (2004), Yatim *et al*. (2006) and Saleh *et al*. (2007). Perhaps defining expertise may need to be expanded rather than focus on accounting professionals only. It may be because pool of resources especially accountants, are still limited in emerging economies such as Malaysia, as compared to a more developed country like US as shown in Table 2.6. The need for accountants who are registered members of MIA is at the ratio of 1 in 95,000. It is a wide gap as compared to Hong Kong, 1 in 4,270 and US especially, at 1 in 109 per capita.

Table 2.6 Accountant's Ratio

Country	Number of Registered Accountants (as at January 2010)	Population (million)	Accountants' Ratio
Malaysia	26,482	28	1 : 95,000
Hong Kong	29,857	7	1 : 4,270
India	63,918	1,198	1 : 500,000
USA	342,562	315	1 : 109

Sources : Compiled by the author from MIA, ICAI, CPA, AICPA, HKICPA and UN Department of Economic and Social Affairs.

Thus, this study would like to extend the literature by examining the audit committee expertise composition in relation to financial reporting quality, which is consistent with Beasley *et al*. (2000), that if an audit committee is not present, the full board's attention to financial oversight may not be as vigilant or effective. And extending 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. Subsequently, the study intends to extend the experts' measurement from a recent study by Saleh *et al*. (2007), which posited that earnings management is lower for firms with an active and knowledgeable audit committee, and complements prior studies on audit committee expertise such as Engel *et al*., (2010), Baxter and Cotter (2009), Coates *et al*. (2007) and Aier *et al*. (2005). The study extends Engel *et al*. (2010) and Baxter and Cotter (2009) by introducing new measure on expertise such as the introduction of other qualification namely academic qualification. Existing description of expertise as shown in Table 2.1 earlier failed to address if a person is academically qualified to be an expert. Most of the studies mentioned work experiences as CPA, CFO, CEO (Zhang *et al*., 2007), accounting experts (Defond *et al*., 2005, Mangena and Tauringana, 2008; Krishnan and Visvanathan, 2008) and also non-accounting experts such as non-financial directors (Engel *et al*., 2010). Engel *et al*.

(2010), introduced a non-financial directors that has no direct financial training or experience, an extension of non-accounting experts from Zhang *et al*., (2007) and Krishnan and Visvanathan (2008) that initially includes other directors who has no direct experience related to accounting and auditing. Further, Baxter and Cotter (2009), examine two types of experts from accounting and legal background, but failed to find any association with experts of legal background. What most of these studies lack is the exact measurement of these experts that will assist users to measure or find these directors from the market, and especially in countries of emerging economy such as Malaysia.

2.8 Research Questions

From discussion above, the study's research questions are; (1) what will be the appropriate measure of audit committee experts that suits the Malaysian corporate governance practices? And (2) is there a relationship between these audit committees experts and financial reporting quality? It is evident that SOA and SEC's description may not be appropriate for Malaysia, an emerging economy, hence shows a gap in the literature to come up with a more appropriate mesure of experts. This is also to tap into the recent call from the latest amendments on MCCG concerning financial literate directors among audit committees, of finding a more designated measure that suits the Malaysian governance scenario. Lastly, consequential from the limited studies focusing on measuring audit committee's expertise and financial reporting quality proxied by both fraudulent financial reporting and earnings management, the study intends to fill in this gap in the literature.

2.9 Conclusion

The chapter reviews prior literature in relation to corporate governance in general, and audit committees specifically. Prior literature suggests that audit committees as among governance mechanism, is important in monitoring the managers' opportunistic behaviour and fraudulent activities in the financial reporting process. However, prior studies failed to address definition or measurement of expertise that fits the board's human capital in an emerging economy such as Malaysia. Hence, the study intends to fill that gap, and contributes to the growing literature on audit committees; at the same time provide some insights on new measurement of experts for emerging countries.