# Chapter 6 CONCLUSION

## 6.0 Introduction

This final chapter discusses the summary of research, implications of the study to theory, stakeholders and researchers. Subsequently, followed by limitations of research and suggestion for future research.

## 6.1 Summary of Research

The objectives of the study are to examine the types of audit committee experts that are appropriate for the Malaysian corporate governance scenario, and to investigate the relationship between audit committee experts and financial reporting quality. The study applies agency theory (AT), resource dependence theory (RDT) and behavioural decision theory (BDT), to examine the audit committee expertise with financial reporting quality. The theories provide the research with an empirical implications or hypotheses that can be investigated by empirical testing. The audit committee expertise is measured by academic, and professional qualification and experiences in managerial position, which were developed from a well designed measurement system that are supported by the behavioural decision theory and experts literature. According to the agency theory, separation between the owner and manager, that resulted in the separation between ownership and control would subsequently leads to the agency costs, such as litigations costs due to fraud cases, or firms' bad performances. In this study, the agent is represented by the board of directors, i.e. audit committee members, while the shareholders are the principals.

Audit committees are viewed as monitoring devices that are used to prevent opportunitistic behaviours and strengthen the quality of financial reporting, hence to mitigate the agency conflicts between preparers of financial statements and outside shareholders. Furthermore, in a resource dependence theory, audit committee is also viewed as directors that link the firm with external resources, to bring in capital such as expertise and experience. These expertise and experience are identified as criterias for experts from the behavioural decision theory. Then, after key variables of interest and other influential factors are established, dependent variables and independent variables are identified to give a better impression of the breadth of the study. Thus helps to answer the first research question related to the types of expertise that are suitable for the Malaysian corporate governance context, i.e. what will be the appropriate measure of audit committee experts that suits the Malaysian corporate governance practices? And this is answered by the three fundamentals criteria established from the behavioural decision theory namely; professional qualification, academic qualification and managerial experiences.

From the formulated theories, the study continues with statistical techniques to validate the hypotheses. The techniques are used to answer the second research question on the relationship of the audit committee expertise and financial reporting quality. Firstly, financial reporting quality is proxied by two different features, namely fraudulent financial reporting and earnings management. As suggested from prior literatures in fraud, fraud firms are selected from the Securities Commissions Announcements and Enforcements in their 2001 to 2008 Annual Reports by way of content analysis. A matched pair sampling is carried out for the sampling, consistent with prior studies. However, samples for earnings management are taken from recent data for year 2008 of top 300 listed companies based on prior year market capitalisation. As much as 267 companies are included for the collection of data, and year 2008 is considered because in October 2007, latest amendments were made on the MCCG. Similarly, data is collected by content analysis.

Following that, a logistic regression analysis is performed for the fraud's sample, while a linear multivariate analysis is utilised for the earnings management's sample. In the fraud's sample, management ownership and accounting affiliated directors, are significant and support the hypothesis ($H_1$) that states, firms with higher proportion of audit committee members with professional accounting affiliations, are less likely to experience fraudulent financial reporting. Similarly, the larger the number of management ownership, the less likely are the incidence of fraudulent financial reporting. The negative coefficients for both variables suggest that, with larger percentage of ownership by directors, and higher proportion of accounting affiliated audit committees, the likelihood of fraudulent financial reporting is lower.

Accounting affiliated audit committees are also documented to be prevalent in the association with discretionary accruals as second proxy to financial reporting quality. Hence, from both measure of proxies, accounting affiliated audit committee experts, is an important determinant to financial reporting quality. Thus confirms the application of the three theories and provide answers to the study's second research question, i.e. is there a relationship between these audit committees experts and financial reporting quality? Accounting affiliated audit committees have a negative relationship with financial reporting quality, suggesting that these experts can help to reduce the incidence of fraudulent financial reporting and lowers the magnitude of earnings management. The larger the number of these experts, the lower the likelihood of fraudulent financial reporting, and the lower the magnitude of earnings management. Consequently improve the quality of financial reporting. These results also confirm the resource dependence theory on audit committee expertise as the resource provider where, the resources are identified as skill, knowledge and experiences, i.e. professional and academic qualification and managerial experiences. These expertise's criterias are relevant to identify an expert, are explained by the behavioural decision theory.

However, most importantly, in both analysis i.e. fraudulent financial reporting and earnings management, professional qualifications are shown to be prevalent. Hence, suggesting that it is an important determinant in financial reporting quality. Therefore supports the behavioural decision theory that advance education is important, and provide answer to the first research question on the types of expertise that is relevant to the Malaysia corporate governance scenario. The results shows that in the Malaysian context, it is relevant to include education as a criteria to measure the audit committee expertise with respect to professional qualification.

Additionally, professional qualification also has a major role contributing to financial reporting quality, whereby knowledge of its value is critical to effective management and maximisation of human capital regardless of their innate ability or socioeconomic status. Hence support the resource dependence theory, that audit committee experts link the firms with external resources, such as expertise and experience. This is proven under both circumstances, i.e. under regulated circumstances (fraudulent financial reporting), as well as selection of accounting procedures and estimates that conform to GAAP (earnings management). The resource dependence theory views, directors as instruments in which organisations can use to deal with external dependencies (Dalton *et al*., 1999). Subsequently, resource dependency theorist emphasised the institutional function of structure, arguing that by increasing in size, and diversity, boards are able to assist firms to secure critical resources including prestige and legitimacy (Goodstein *et* *al*., 1994; Pearce and Zahra, 1991). Thus, the findings are consistent with the IFAC[15] Proposed Framework for International Education Standards for Professional Accountant, Exposure Draft 2009 (IFAC, 2009). Where the Framework is targeted to meet the needs of International Federation of Accountants (IFAC) member bodies, but is relevant to a wide range of accounting education stakeholders, including, accounting faculty at universities, employers of professional accountants, professional accountants, prospective professional accountants, and anyone interested in the work of the IAESB.

## 6.2 Implications

The study has implications on theory, stakeholders and policy makers. There is also implication to private sector such as, for corporate boards in appointing audit committee members, and for auditors in developing strategies for communicating with audit committees and assessing their effectiveness (Beasley and Salterio, 2001).

### 6.2.1 Implications for Theory

The agency theory emphasise the need for directors to monitor the activities of the board. The agency relationship theorise that the presence of independent director with specific financial training and experience will reduce the incidence of management irregularities or fraud, where the underlying assumption is that the directors with accounting and/or finance background are more likely to be aware of the financial representation activities than directors without such background. In the case of agency theory, the findings failed to evidence that independent audit committees have a negative relationship with fraudulent financial reporting.

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[15] IFAC is a worldwide organisation for the accountancy profession founded in 1977, and comprised of 159 members and associates in 124 countries and jurisdictions.

On the other hand, agency theory provides rich conceptual foundation to explain that experiences, skills, and capabilities i.e. qualifications (Arthurs *et al*., 2009), as part of the governance process to oversee the top management and protect the interests of the shareholders. It is shown that the audit committee accounting experts have negative relationships with fraudulent financial reporting, as well as in the earnings management, as theorised by the agency theory. Thus, support earlier study by Barney (1991), human capital with firm's specific skills and capabilities have potential to turn intangible resources into sources of competitive advantage.

The study shows support that additional theory is needed to explain board of directors' expertise and experience, other than the agency theory that is almost grounded in prior literature within the accounting domain (such as Menon and Williams, 1994; Rager, 2004; Piot, 2004). Assumptions made in agency theory about individualistic utility motivations resulting in principal-agent interest divergence may not hold for all managers (Davies *et al*., 1997), such as the independence of audit committee as shown in the analysis. Furthermore, results in Nicholson and Kiel (2007) indicate that high monitoring alone is no guarantee of corporate performance, eventhough Peasnell *et al*. (2005) noted that outside directors act as a measure of board monitoring that contribute towards the integrity of financial reporting.

Therefore, focusing on the monitoring aspect only, agency theory appears to discount the impact of other board functions, eventhough agency theory supports the role of board of directors for monitoring and control (Daily *et al*., 2003). Hence, combining two other theories to explain the monitoring functions of the board as well as the composition of expertise of the boards (from the resource dependence theory and behavioural decision theory), with agency theory seemed appropriate and complements prior studies such as Hillman and Dalziel (2003), Hillman *et al*. (2007) and Dalton *et al*. (1999), Arthurs *et al*. (2009) and Engel *et al*. (2010). Engel *et al*. (2010) lacks the explanation and support with the theoretical foundation in providing their types of expertise.

The findings show RDT is prevalent in accounting or auditing domain, where there is evidence showing directors represented by audit committee experts, bridge firms with external resources such as expertise and experience. Where expertise and experience are identified as professional and academic qualifications and managerial experience, explained by BDT. Subsequently, contribute to the mainstream accounting literature that the RDT and BDT are vital in explaining situations where directors' expertise and knowledge are involved. Hence, explains that, the mere presence of independent directors as monitoring mechanism is insufficient. It is also important to explain and links the background and knowledge expertise the directors have that can be use to assist them in their functional role as audit committee members. Therefore, the expertise and experience that audit committees expertise acquired from outside the organisation, are relevant to be used as a measure of expertise.

Resource dependence theory emphasise the institutional function of structure, maintaining that by increasing the size, and diversity of board membership, boards are able to assist firms to secure critical resources including prestige and legitimacy (Pearce and Zahra, 1991; Goodstein *et al*., 1994). This rationale is adopted to explain the need for independent audit committee members who are also professionally qualified experts. Hence, the theories complement each other, where the agency theory explains the monitoring role of the boards, and resource dependency theory explains the overall significant impact of board's expertise. Whilst the behavioural decision theory explains the criteria that are relevant to identify an expert, i.e. based on his or her qualifications and work experience. Consequently, the role of corporate governance may go beyond protecting or distributing profits, but also moving towards gaining competitive advantage in knowledge, skills, and expertise towards financial reporting quality.

### 6.2.2 Implication to Stakeholders

Since qualification and experience proved to be important, stakeholders may consider qualification and experience of a person before appointing them as audit committee members. Currently companies must appoint at least a person with an accounting background as ruled out in MCCG 2007. Therefore, options should also be given to those with prior experience in senior managerial positions, and academically qualified person, among their audit committee members. Hence, strategic decision could be gained towards the objective of quality financial reporting, as stated by Castinas and Helfat (1991) that the key function of the board is to set broad strategic direction for the company and make major policy decisions. Where the expertise of the board is of prime importance, supported by Felo *et al*. (2003) that suggest having more than one expert in accounting or financial management on the audit committee may be beneficial to firms, and Barbadillo *et al*. (2007), managers' interest are represented in the board, where managers can impair the effectiveness of audit committee through the creation of management dependence audit committee when they are able to influence the decision making process of the board. As Rezaee (2007) pointed out, the effectiveness of financial advisors depend on their professional objectivity, independence, training and experience. Therefore, having qualified experts on the board, will improve effectiveness and help strengthen the governance and interanl control of the organisation, thus give more confidence to the stakeholders.

Legislators or policy makers, such as the Securities Commission, may provide incentives and encouragement to directors of listed companies in pursuing tertiary education. It is an advantage for firms in developing and protecting themselves for having directors with specific skills and capabilities, whereby these skills have potential to turn into sources of competitive advantage (Barney, 1991), such as quality financial reporting. Furthermore, Barbadillo *et al*. (2007) suggest that regulators might persist in searching for ways to guarantee that management will not be able to limit the control function of audit committee. Subsequently, board of directors should be comprised of members who do, in concert, fill the separate roles such as directors offering local expertise, training and succession (Dalton *et al*., 1999).

In addition, since it takes time to train and accumulate human capital, in particular those with higher education (Li *et al*., 2009). The government or organisation should facilitate more efficient allocation of human capital by resorting relevant trainings and forms of incentives. So that, in the future, there will be more qualified and experienced directors for firms to consider as their directors.

The study shows that tertiary education at postgraduate level has an association with financial reporting quality. Therefore pursuing tertiary education might be useful and value added to directors' qualification. As proposed by IFAC (2009), this could increase public trust and improve the quality of the accounting profession. In addition to that, World Bank (1982) finds that education is the single most important key to poverty alleviation and tertiary education increases income from 82% to 300% in WEI countries. Additionally, MIA could encourage their members to increase their knowledge and education, by working with allies such as universities that offer postgraduate courses with CPE points.

Finally, human capital is the core production input of a public accounting firm, an expertise intensive and labour intensive service organization. Thus, a way to improve an auditor's professional competence and skill, are through the CPE that are consistent with practical matters and specific firm needs (Chen *et al*., 2008). Supported by (Pitelis, 2009) that one needs prior knowledge, including the very capacity to obtain knowledge, for things to be implemented and applied.

### 6.2.3 Implication for Researchers

For researchers, the findings suggest that professional and academic qualification are associated with financial reporting quality. Hence, future studies may consider qualification as input factors to consider as experts. Other than that, researchers could consider other areas of expertise, other than accounting that might have an association with financial reporting quality. Such as prior studies that had considered other field or profession, such as lawyers as other professional expertise, and suggested having more than one expert in accounting or financial management on the audit committee may be beneficial to firms.

## 6.3 Limitations of Research

### 6.3.1 Sample

The study has a number of limitations when evaluating the results. Firstly, in the fraud sample, the relative infrequency of financial reporting fraud is fairly small, only 28 firms from approximately 900 public Malaysian firms had been discovered (at the time of data collection) to have engaged in fraudulent financial reporting under the strict selection of standards the study had set. This number of transgressive firms resulted in a matched pair sample of 112 firms in total. Data limitation is considered consistent or sufficient for the analysis, as other studies of similar method had shown to face limitation of data too. Relative infrequency of fraudulent financial reporting sample fairly small, consistent with studies conducted in the US, where it reported only 65 fraud firms were found among the 9600 US public companies. Even though the matched pair design is relatively powerful, consistent with prior, but must be carefully interpreted for generalisation (Zhao and Chen, 2008). Thus, findings is limited because of the small sample and generalisation should be made with careful consideration, especially on developed countries with high investor protection, less family ownership, high reliance on public debt, less concentrated and no pyramidal ownerships, because the incentives to expropriate minority shareholders' wealth is less (Saleh *et al*., 2007).

### 6.3.2 Corporate Annual Reports

The study focuses on corporate annual reports, consistent with many prior studies where directors information in the annual reports and is considered under voluntary disclosure. And such disclosures do not mean that they are credible or reflecting the true state of affairs of the company (Ho and Wong, 2001).

## 6.4 Recommendations For Future Research

The mainstream research world view has produced benefits for the conduct of accounting research with its insistence on public, intersubjective tests and reliable empirical evidence. But, this has limited the type of problems studied, the use of research methods, and the possible research insights that could be obtained (Chua, 1986).

### 6.4.1 Other Expertise

Future research can expand in finding the field of expertise or professional recognition other than accounting, and how they could contribute to the financial reporting quality of the organisation. Further investigation could be examined if professional recognition that are related to the nature of the business or their experiences in related field, that actually help in achieveing the quality of financial performance. Consistent with Goh (2009), audit committee with greater non accounting financial expertise and more independent boards are more likely to remediate material weaknesses in a timely manner. Therefore, role of non accounting financial experts shall be further researched to investigate their contribution in financial reporting.

### 6.4.2 Academic Qualification

The research can be extended in examining academic qualification in more depth, rather than just a general proclaimation of postgraduate courses. Subsequently, this is in similar direction with the Exposure Draft 2009 by the IAESB on the Proposed Framework for International Education Standards for Professional Accountant (IFAC, 2009). The study shows that there are many field or discipline that directors had attended or acquired academically and professionally. Further research on these fields will help to understand directors behaviour and effectiveness better, in terms of their contribution to financial reporting quality. Furthermore, further studies may substantiate which discipline actually reflects the true contribution towards the companies' performance.

## 6.5 Conclusion

From prior literature the study draws upon three theories to provide the underlying foundation to build the hypotheses. Firstly, the agency theory provides the framework to represent the audit committee as agents to the stakeholders and one of the governing mechanism in the organisation. Secondly, resource dependence theory views directors as the provider of external resources such as expertise and experience. And thirdly, the behavioural decision theory assists in determining the experts criterias on work experiences, and qualifications. The study includes two factors namely the academic qualifications and work experience into the model, and found significant results that provide contribution to the body of knowledge. Therefore, merely measuring audit committee financial expert with accounting professional qualification as prior studies had examined could be extended, and relevant to include academic qualifications in measuring an audit committee expert. Hence, experts could be determined from their work experiences, professional qualifications and academic qualification, as compared to the existing literature that use professional qualification only. The three theories complement each other with respect to audit committee expertise. Whereby, agency theory explains the function of audit committee experts as monitoring mechanism. While RDT explains that audit committee experts as resource provider to the organisation. And these resources are identified as expertise and experience, which are explained in depth by the BDT. The study extends earlier studies on audit committees, with the inclusion of other experts in the audit committee, have proven to give some significant impact towards financial reporting quality. Finally, the adoption of RDT and BDT, with agency theory in the accounting domain transcribe that, preparers of financial statements (agents) are not only responsible to report to the shareholders (principal) but, are also responsible to seek external expertise in order to produce quality financial reporting and mitigate the agency costs.