A Conceptual Model of Audit Committee Effectiveness towards Financial Reporting Quality in Malaysia

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Abstract

The issues of financial reporting quality relating to accrual earnings management (AEM) and real earnings management (REM) are essential to academics, professionals and regulators. The interest in examining earnings management is due to the assumption that such behaviour may lead to serious activities such as fraudulent of financial reporting. Financial decisions that are based on mislead financial statements will hurt company's credibility in the eyes of stakeholders. Therefore, many countries including Malaysia have emphasized on the role of good corporate governance practices particularly with regards to the function of board committees. An audit committee has significant roles to ensure that financial statements produced by a company is fair and accurate. The main objective of the current study is to examine the effect of audit quality on audit committee towards financial reporting quality in Malaysia. Besides, it also aims to determine the moderation effect of audit quality on the relationship between board committees and financial reporting quality. The study uses secondary data of Malaysian public listed companies. The results of the study will fill the gap in corporate governance literature and report the importance of audit committee in ensuring the quality of financial reporting in an emerging economy such as Malaysia.

Keywords: Audit committee, Financial reporting, Earnings management, Malaysia, Quality

1.0 Introduction

Financial statements should not be intentionally prepared to mislead the users but they must provide reliable, timely and relevant information to assist users in decision making (Kibiya, Che-Ahmad & Amran, 2016). Earnings management practices are considered as real earnings management (REM) and accruals earnings management (AEM) (Roychowdhury, 2006; Cupertino, Martinez, & Da Costa, 2015). Previous studies found that managers choose between the two EM strategies (Braswell & Daniels, 2017), or jointly and simultaneously use these tools when engaging in EM (Chen, Huang& Fan, 2012). The objective of the study is to examine the effect of board committees namely, audit committee towards financial reporting quality based on Jesen and Meckling's (1976), and as Watts and Zimmerman's (2014) agency theory, as well as Pfeffer and Salancik's (1978) resource dependence theory. This study investigates the audit quality in Malaysian listed companies and more specifically it examines how audit quality moderates the relationship between board committee, namely, audit committee and quality of financial reporting (FRQ). In as among others 1 Malaysian Development Berhad, and Felda Corporation demand for further research on audit committee effectiveness, audit quality and financial reporting quality.

In this paper, three conceptual models are developed. The first model explains the board committee and financial reporting quality. The second model examines the relationship between audit quality on FRQ. The third framework explains on the moderating model. In the following section the board committees, namely, audit committee variables are discussed followed by the development of three conceptual models. Finally, the potential contributions of the study are presented.

2.0 Empirical Review

The dependent variables are presented by FRQ proxy of earning management (REM & AEM) by Enomoto, Kimura and Yamaguchi (2015). Meanwhile, the audit committee is assumed to have significant effect on the earning management. Besides, the moderating variable is presented as the effect of audit quality on the audit committee and quality of financial reporting in Malaysian listed firms. Several studies empirically document type of auditor as a factor in explaining financial instrument disclosure. Jensen & Mackling (1976) argue that an audit firm acts as a good corporate governance mechanism to reduce agency costs and to provide oversight by mitigating the opportunistic behaviour of managers. The literature argues that larger and more well-known international auditing firms act as sources of inspiration for companies to disclose more financial instrument risk information to maintain the audit firm's reputation and to avoid unnecessary reputation cost (Chalmers & Godfrey, 2004). Earlier empirical studies in Malaysia such as Marzuki, Wahab and Harun (2016) Mohammad, Wasiuzzaman and Salleh (2016), Abdullah & Ku-Ismail (2016), Ahmad-Zaluki, Campbell & Goodacre (2011), Kamardin & Haron (2011), Mohamad et al. (2012) have investigated some relationships between the corporate governance mechanisms and earnings management using (accrual) proxy either by discretionary accruals, abnormal working capital accruals, and board performance among others. However, it can be concluded that none of these studies has thought of examining the impact of these mechanisms on the aspect of real operating and investment decisions of the company.

2.1 Earnings Management

The earning management is thus viewed as the use of accounting choices to manipulate reported earnings to manager's benefit. It may also be defined as the reasonableness of legal decision-making and reporting of financial outcome with the intent of achieving earnings stability (Nahandi, Baghbani & Bolouri, 2012). EM can be good when it is used as a vehicle for the communication of management's internal information to investors. Cohen et al. (2008) classify real EM as the three following manipulation methods: first, providing discounts to stimulate sales or granting lenient credit terms, second, decreases the cost of goods by increasing production, and third is decreasing the expenses that is considered discretionary such as research and development and advertising expenses. Real EM is used as alternative method to manage earnings rather than accruals method or using both methods to manage earnings.

2.2 Audit Quality

The quality control means compliance with accounting and auditing standards, applying a deep and broad understanding of the business and financial environment of customers on how they work, using specific expertise to solve problems and solve them early. And practicing professional uncertainties in all aspects of the project. Asare, Davidson, and Gramling (2008) describe the critical situation of internal auditors and their motivations for managing errors in financial statements. The role of internal auditors is to ensure quality audit by ensuring that there is no discrepancy in reporting. Their role is also to help prevent fraud by ensuring that appropriate mechanisms are in place and implemented. The Audit Committee is responsible for ensuring that accurate financial information (Buchalter & Yokomoto, 2003), auditor independence, audit possession and audit fees have a positive impact on audit quality (Rahmina & Agoes, 2014).

2.3 Audit Committee

2.3.1 Audit Committee Independence

With regards to the effectiveness of audit committee (AC), it should comprise non-executive directors, who are not related to and are independent from the management (Ika & Ghazali, 2012). Prior studies in some of emerging markets provide evidence on the relationship between AC independence and FRQ. For instance, Al-Rassas and Kamardin (2016) examine the effect of internal and external audit qualities, AC attributes, ownership concentration and earning in Malaysia. Porreti et al. (2018) examine whether autonomous director in the AC has influence on the market reaction of Western Europe. Setiany (2018) explores the influence of board attributes on earning quality in Indonesia. They reveal that AC independence has a negative significant relationship with discretionary accruals.

2.3.2 Audit Committee Financial Accounting Expert

AC members with financial expertise are essential to help them to understand accounting numbers and monitor the financial reporting process to enhance the financial reporting quality. The Revised Code on Corporate Governance in Malaysia required all members of audit committees to be financially literate and at least one should be a member of a professional accounting association. It is crucial for companies to have AC members who are experts in finance as they can support the financial statement's credibility (He & Yang, 2014; Sharma & Kuang, 2014; Soliman & Ragab, 2014). Hillman et al. (2009) explain that the resource dependence theory posits that directors' role is not only about reducing uncertainty, they also provide advice in a variety of strategic areas and valuable expertise. In order to tackle the issue of AC's oversight, in the context of Malaysia, Shawtari et al. (2016) reveal that AC financial accounting expert is related to reduce EM.

2.3.3 Audit Committee Meeting

The revised MCCG (MCCG, 2007) mandated that four meetings should be held annually for AC effectiveness. Using a sample of 280 listed firms on Bursa Malaysia in 2005, 2006, 2008 and 2009, it is found that there is a positive association between the frequency of AC meetings and EQ (Salleh & Haat, 2014; Shawtari et al. (2016). However, an insignificant association is found between the frequency of AC meetings and EQ in Malaysian firms (Shahkaraiah & Amiri, 2017; Abdullah et al., 2014). The AC is not capable of fulfilling positive impact on financial reporting quality, even with suitable composition and resources if it is not active (Albersmann & Hohenfels, 2017).

2.3.4 Audit Committee Size

Globally, most of corporate governance has addressed the size of the AC in several recommendations that it established such as the Cadbury Report (1992) and the Smith Report (2003). These reports mandate that the number of AC members should be at least three. Similarly, the Sarbanes-Oxley Act (2002) stipulates that three as the minimum number of members in the AC. In the context of Malaysia, the Revised Code on Corporate Governance stipulated that to be effective the AC should comprise at least three members (MCCG, 2007). Mohammad, Ahmad and Ji (2017). Give one or two the influence of corporate governance, political connections and accounting conservatism in Malaysia. They utilize a sample of 206 companies for the period of 2004 to 2007. The study reveals a positive significant association between AC size and accounting conservatism. Equally, Kamarudin, Wan Ismail, and Ibrahim (2017) explore whether AC supports the informative or deceptive implication of creative accounting in Malaysia.

3.0 Development of Conceptual Framework

Many studies have investigated the direct association between AC variables and EM. Referring to the framework, the model will investigate the moderating influence of audit quality on the association between audit committee with EM. The study will control for firm size and firm leverage, as they have been shown to have an impact on EM in previous studies (Guo et al., 2015; Roychowdhury, 2006; Wang, 2006).

3.1 Dimensions of board committee process

This study identifies two critical processes for board committees namely, audit committee and risk management committee. The study adopts variables which include audit committee comprising independence, financial expertise, meeting, size, and risk management committee consisting of separation, independence, financial expertise, and gender diversity being the independent variables. The dependent variables are represented by FRQ proxy for earning management (REM & AEM) by Enomoto, Kimura and Yamaguchi (2015).

3.2 Audit Committee

3.2.1 Audit Committee Independence

According to Mohd Saleh et al. (2007), an AC whose members are mostly independent can adequately supervise management and prevent the opportunity for EM practices since they are free of unnecessary interferences from firm executives. Moreover, Ye, Carson, and Simnett (2011) argued that independent AC members are a cornerstone for financial reporting process as they promote the quality of financial statements of the firm. In an attempt to enhance the control function of the AC, the Bursa Malaysia Listing Requirement requires three non-executive members to be on the AC, a majority of which must be non-executive directors. De Vlaminck and Sarens (2015) in the context of Belgium found independence of AC reduce EM, which in turn improve the quality of financial reporting. Similarly, in China, Chen and Zhang (2014) and Lin, Hutchinson, and Percy (2015) found independence of the AC curbing EM by lowering abnormal accruals. Recently, Kapoor and Goel (2016) and Komal and Bilal (2016) documented that audit committee independence is the major determinant of audit committee effectiveness to enhance their oversight role and confine EM. In the Malaysian context, Mohd Saleh et al. (2007) found a negative relationship between the percentage of independent members on AC and EM. The same result was confirmed by Al-Rassas and Kamardin (2015; 2016) who provided evidence that audit committee independence is significant to lower EM.

3.2.2 Audit Committee Financial Accounting Expert

It is an important characteristic that AC members possess financial expertise to help them to understand accounting numbers and monitor the financial reporting process in enhancing the financial reporting quality. The Revised Code on Corporate Governance in Malaysia required all members of audit committees to be financially literate and at least one should be a member of a professional accounting association (MCCG, 2007). It is also revealed that in the context of Malaysia, AC financial accounting expert is related to reduce EM (Mohd Saleh et al., 2007; Shawtari et al., 2016; Md Yusof, 2010).

3.2.3 Audit Committee Meeting

The frequency of AC meeting is used as a proxy for the committee's activity level (Menon & Williams, 1994; Xie et al., 2003). In order for AC to be more effective, frequent meetings allow for best communication between AC and the external auditors (Zaman, Hudaib & Haniffa, 2011).

3.2.4 Audit Committee Size

Mohammad, Ahmad and Ji (2017) examine the influence of corporate governance, political connections and accounting conservatism in Malaysia. They utilize a sample of 206 companies for the period of 2004 to 2007. The study reveals a positive significant association between AC size and accounting conservatism. Equally, Kamarudin, Wan Ismail, and Ibrahim (2017) examine whether AC supports the informative or deceptive implication of creative accounting in Malaysia. They argue that AC independence supports the deceptive proponent of creative accounting practise as evidence by an inversely association between AC size and income smoothing behaviour of firm.

3.3 Earnings Management (AEM & REM)

The current literature categorises EM into real earnings management and accrual earnings management (Cupertino et al., 2015; Gunny, 2010; Roychowdhury, 2006). When engaging in EM, directors have the option of choosing between real or accrual EM. According to Alexander (2010), the manipulation of earnings based on real activities has been widely used in recent scandals (examples are Enron, Lehman). However, it has been overlooked in the literature (Yaping, 2005). Alexander (2010) attributes the lack of research on REM to a shortage of causal models, which precisely measures EM through real activities at that time. However, since Roychowdhury (2006) produced the model to fill this gap in the literature, a remarkable amount of work has been done to determine the use of the two kinds of earnings manipulation. In an endeavour to contribute to the above literature, this study investigates the moderating role of audit quality on audit committee effectiveness to discourage the harmful effects of the types of EM in the developing market of Malaysia. To achieve this, the determination of REM is critical.

3.3.1 Accruals of Earnings Management

Accrual earnings management (AEM) is a technique based on exploiting accounting flexibility offered by the Generally Accepted Accounting Principles (GAAP), such as choice and changes in accounting principles or accruals estimates (Vander Bauwhede & Willekens, 2003). In the accounting literature, this is called “within-GAAP EM”. In other words, AEM is a method that employs the use of accounting judgement about the timing of recognition of revenues and expenses. Therefore, the accrual method does not impact the cash flow element of earnings. It also does not affect the cash position of firms. Rather, it deals mostly with non-cash expenses meant to manipulate the declared earnings.

3.3.2 Real Earning Management

Real earnings management involves activities related to real production, operating and investment decisions such as cutting research and development, high production cost and low discretionary expenses (Matsuura, 2008; Visvanathan, 2008). The latter is considered a good tool for earnings management practices because it is a signal of better performance, which could have a positive impact on a company’s value (Gunny, 2010) does not affect a company’s’ value (Roychowdhury, 2006) and may impair company value (Cohen & Zarowin, 2010; Hashemi & Rabiee, 2011; Sari et al., 2010; Visvanathan, 2008; Zhao et al., 2012) because manipulation done in the current period could have a negative effect on the cash flow in the future period. Specifically, it allows the manager to attain reporting goals.

4.0 Construct of Conceptual Framework

4.1 Conceptual Research Framework

Many studies have investigated the direct association between Board Committee, Audit Quality and Financial Reporting Quality. Referring to the framework, the model investigates the moderating influence of Audit Quality on the association between Board Committee, namely, Audit Committee with Financial Reporting Quality which is represented by EM as a proxy AEM and REM (Gholamreza Zandi et al., 2019). The theoretical framework of this study is grounded in the previous literature. Size, and firm leverage, are considered as the control variables since in previous studies they have been shown to have an impact on EM (Guo et al., 2015; Roychowdhury, 2006; Wang, 2006). The conceptual framework is developed as shown in Figure 4.1.

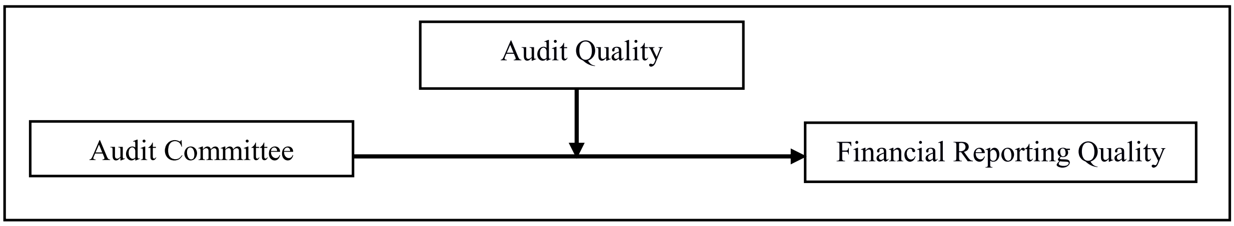

Figure 1: Conceptual Framework of the Research

4.2 Analysis Model

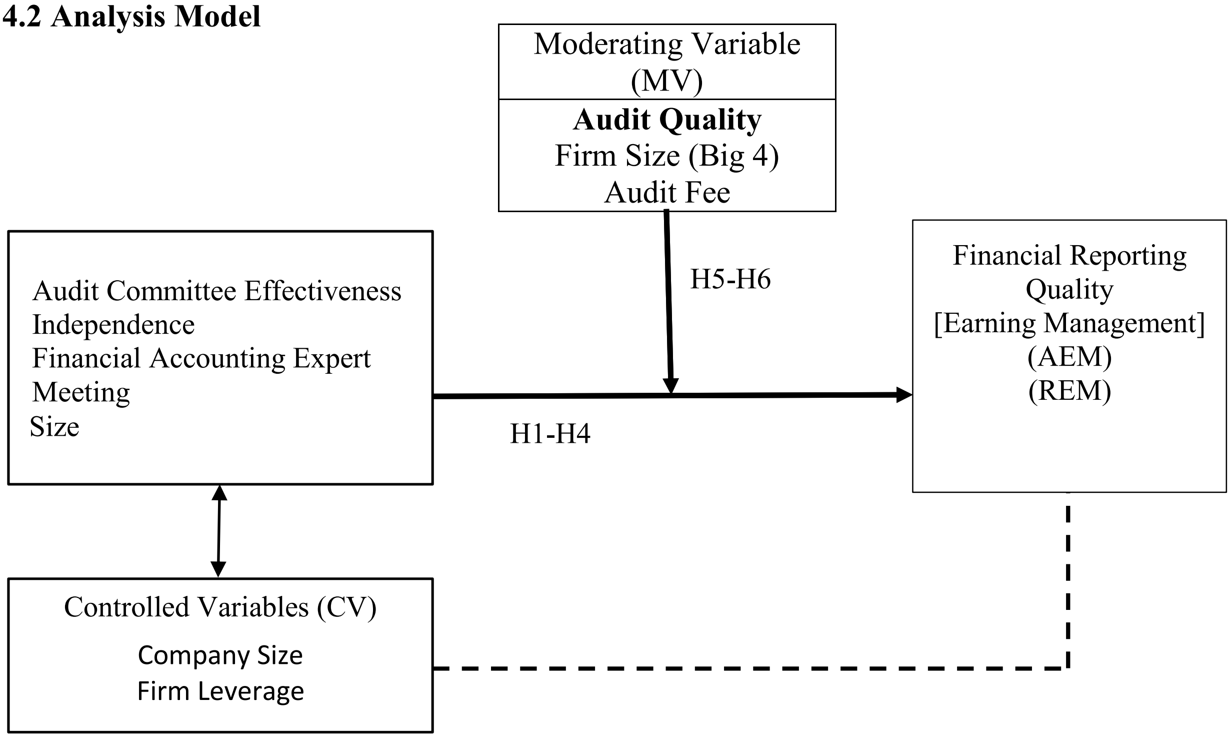

Figure 2: The Research Framework of the Relationship between Board Committee and Quality of Financial Reporting (Earnings Management)

5.0 Development of the Research Hypothesis

5.1 The Relationship between Audit Committee and Quality of Financial Reporting

5.1.1 Audit Committee Independence (ACIND)

The resource dependence theory posits that independent directors play a significant role in providing particular resources that are unavailable to the management. The extant studies found that committee independence correlated negatively with audit committee independence and earnings management (Kamarudin, Wan Ismail & Ibrahim, 2017). This validate some studies that AC Independence has positive influence on discretionary accruals and restatement (Al-Rassas & Kamardin 2015). This indicates that higher ratio of AC independence on the board is correlated with higher level of abnormal accruals and the likelihood that firms restate earnings. This is affirmed by the recent study of Poretti et al. (2018) which contend that the more the percentage of independence directors in the AC of companies, the higher the market reactions to earnings pronouncements. Moreover, Amin et al. (2018) reveal that AC independence has a negative relationship with discretionary accruals. Hence, it is hypothesized that:

H1a: Audit Committee Independence is negatively associated with earnings management (AEM) among Malaysian listed companies.
H1b: Audit Committee Independence is negatively associated with earnings management (REM) among Malaysian listed companies.

5.1.2 Audit Committee Financial Accounting Expert (ACFEX)

The resource dependence theory explains that the AC's role is to provide resources in the form of expertise and experience in order for firms to gain competitive advantage, especially in financial reporting quality. These experts are expected to mitigate the agency problem that arises from the managers' ability to manipulate earnings reports. This is because they indicate support for the financial statement credibility, hence AC's having financial expertise have been considered as a strength (Burrowes & Hendricks, 2005), as lower EM (Badolato et al., 2014) and high quality earnings reporting is expected to occur (He & Yang, 2014). However, some studies (Katmon & Al Farooque, 2015) found insignificant relationship between AC financial expertise and discretionary accruals. On the other hand, Carrera et al. (2017) examine AC and FRQ in US. This indicates increasing proportion of AC members with financial accounting expertise decreases FRQ. Having financial expertise in the AC shows that the internal audit programme will although independent directors with financial backgrounds might be monitored with good intentions, it is desirable for monitors to have sophistication in financial matters to detect financial. However, there is no response to the employment of a financial expert with a non-accounting background. Therefore, the following hypotheses are formulated:

H2a: The financial expertise of the audit committee is negatively associated with earnings management (AEM) among Malaysian listed companies.
H2b: The financial expertise of the audit committee is negatively associated with earnings management (REM) among Malaysian listed companies.

5.1.3 Audit Committee Meetings (ACMEET)

Consistent with the agency theory, Beasley et al. (2009) argue that members of the Audit committee are committed to meaningful and substantive meetings which still in turn lead to better monitoring and improve financial reporting process. Previous literature contended that frequency of AC meeting reduces the degree of financial restatement. Habbash and Alagla (2015) argue that more frequent meetings reduce discretionary accruals and enhances FRQ. In contrast, other studies report insignificant relationship between AC meeting discretionary accruals (Bamahros & Bhasin 2016; Habbash & Alagla 2015). An increase in frequency is an indication that the committee is more efficient and committed to producing quality performance (Abbort, 2016). More recently, Shankariah and Amin (2017) examine AC quality and FRQ in India, and the study reveals that AC meeting has negative significant impact on FRQ proxy discretionary accruals. The hypotheses are stated as below:

H3a: ACMEET is positively associated with earning management (AEM) among Malaysian listed companies.
H3b: ACMEET is positively associated with earning management (REM) among Malaysian listed companies.

5.1.4 Audit Committee Size (ACSIZE)

With respect to resource dependence theory, AC size has been considered to highly resourceful, thereby improving the FRQ as a result of diverse skill expertise and experience they share amongst themselves (Dhaliwal et al., 2010). In addition, Setiany et al. (2017) examine AC attributes and voluntary financial disclosure in Indonesia, and the study reveals that AC size has positive significant influence on voluntary financial disclosure of firms. Mohammed, Ahmad and Ji (2017) reveal a positive significant association between AC size and accounting conservatism. However, other studies found insignificant relationship between AC size and FRQ (Jatiningrum et al., 2016; Bamahros & Bhassin, 2016). This led to formulating the hypotheses:

H4a: ACSIZE is negatively associated with earning management (AEM) among Malaysian listed companies.
H4b: ACSIZE is negatively associated with earning management (REM) among Malaysian listed companies.

5.1.5 Audit Quality as a Moderating Variable

Although both banking as well as the insurance industries fall under the financial sub-sector, this study argues that financial instrument disclosure may vary with the type of industry. The present study uses audit fee to proxy audit quality. Johl, Kaur and Cooper (2013) analyzed a single dataset of 64 companies (128 observations) listed on Bursa Malaysia for 2009-2010, which was obtained through the administration of a survey questionnaire to chief audit executives (or equivalent position). The first assessment showed that IAF quality was positively associated with EM, signifying reduced FRQ. Asare, Davidson and Gramling (2008) presented the internal auditors' critical position and incentive to manage misreporting financial statements. They also found that there could be a rise in the budgeted hours worked if management tendency were to misreport increase. Internal auditors were critical to variances in the quality of audit committee and would be invested in their valuation of fraud risk and audit scheme.

5.1.5.1 The Moderating Effect of Firm Size On the Relationship Between Audit Committee Effectiveness and Financial Reporting Quality

Manager who acts as a shareholder at the same time can increase the value of the company, so as a shareholder, its value of wealth will also increase. The size of a company can determine how much profit management practices are performed by a company manager. Large companies tend to be cautious in managing companies and tend to manage earnings efficiently. There are two views about the firm size on earnings management. In the first view, the small sized company is considered to do the practice of earnings management more than the big companies. Financial reporting quality is fundamental to the decision making process of users especially the investor group who relied basically on financial statement audited by an external auditor. From the discussion of results and findings, the study concludes that the size of accounting firm plays a vital role in achieving a high quality of financial reporting as it is found that the companies under review engage mostly the Big4 audit firm in auditing their financial statement than the non-Big4 which impacted positively on the quality of financial reporting (Jerry & Saidu, 2015).

H5a: Firm Size has a moderating effect in the relationship between audit committee effectiveness and earnings management (AEM)
H5b: Firm Size has a moderating effect in the relationship between audit committee effectiveness and earnings management (REM)

5.1.5.2 The Moderating Effect of Audit Fee On the Relationship Between Audit Committee Effectiveness and Financial Reporting Quality

More recently Asthana, Khurana and Raman (2018) examine fees competition amongst Big 4 auditors and audit quality in US. They show that fees competitions are valued as essential mechanism for enhancing audit quality in the vastly concentrated US audit market. Knechel, Mintchik, Pevzner and Velury (2018) examine the impacts of widespread trust and community cooperation on audit fees amongst different countries in the world. They reveal that countries with higher trust and community cooperation have high likelihood to expense on a strong audit job to request higher auditing services. They argue that countries with greater trust and community cooperation reimburse higher audit fees to demand greater assurance. This case endorses hat countries with higher extensive trust or greater public cooperation pay higher price on auditing services and hence are prepared to pay higher audit fees. From the emerging market, Al-Dhamari, Al-Gamrh, Ku Ismail and Ismail (2018) explore the link between related party transactions and audit fees in Malaysia. They indicate that audit fees are high for firms that engage in related party transactions including the acquisition and sale of assets, goods, and services.

H6a: Audit Fee has a moderating effect in the relationship between audit committee effectiveness and earnings management (AEM)

H6b: Audit Fee has a moderating effect in the relationship between audit committee effectiveness and earning management (REM)

6.0 Conclusion and Recommendation

Comprehending the issues relating to AEM and REM is essential to academics, professionals and regulators. In spite of the growing recognition of the relevance of AEM and REM in the literature, the number of studies that address this important issue is still limited (Sun, Lan & Liu, 2014). This study updates knowledge about the Malaysian earnings management and offers evidence on the factors that affect EM in Malaysia. Another contribution of this study is to find out which types of corporate governance mechanisms are more likely to influence EM. Hence, the results of this study fill the gap in the corporate governance literature and provide evidence about an emerging economy such as Malaysia. Also, it fortifies the views of the importance of the agency theory and resource dependence theory in analysing the practices of corporate governance and EM in the Malaysian environment. Regarding practical significance, this study is expected to help several concerned parties to understand the level of both types of earnings management by Malaysian firms. For Practical contribution, this study will help the investor and stakeholder to make a decision on investment by looking at the firm that has lower risks with higher profitability.

There are lots of evidence on the impact of Audit Committee (AC) and financial reporting quality (FRQ) around the globe, for example, some studies examine the relationship between AC and FRQ (Haji & Anifowose, 2016; Zgarni, Moses et al., 2016) or audit quality and FRQ (Defond & Zhang, 2016; Nawaiseh, 2016) and the joint impact of AC and audit quality on FRQ (Saleem & Alzhobi, 2016; Bamahros & Wan Hussin 2015). Some studies also examined the interaction of AC and audit quality on the association between AC attributes and FRQ using different construct as proxies for audit quality. For instance, Zgarni et al. (2016) used Big 4 auditors, audit tenure and audit industry specialization to moderate the association between AC and EM. Alzoubi (2016) employed auditors as a moderator on the impact of AC, audit quality and EM. They found that the interactions of audit quality proxy by audit tenure and Big 4 auditor and AC Effectiveness significantly reduces EM and improves FRQ. However, there is limited evidence from the prior literature that empirically examines audit committee towards financial reporting quality represented by EM as proxy (AEM & REM). Besides, it is interesting to determine the moderation effect of audit quality proxy by audit fee and big 4 auditors on the relationship between board committees and financial reporting quality by EM as proxy (AEM &REM) in Malaysia.

Since this study only uses secondary data as its main source, it focuses only on trading companies; future research should seek to explore all types of listed businesses in Malaysia, including banking. Primary data may also be gathered to obtain more authentic information from auditors and other respondents. Referring to the framework, the model will investigate the moderating influence of audit quality on the association between audit committee with EM in REM. It employs audit quality, audit committee and quality of financial reporting as constructs to determine their interrelation. To this end, three hypotheses were formulated to study the relationships between the audit committee and quality of financial reporting, and between audit quality and quality of financial reporting. Future research can also be performed on the audit quality in a different setting through replication of the current study for validity and reliability purposes.

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