

The Impact of Audit Committee and External Auditor Characteristics on Financial Reporting Quality among Malaysian Firms

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Abstract

The quality of a financial reporting system is highly dependent upon the mechanism of corporate governance, such as effectiveness of the audit committee, external audit, financial expertise and board structure. This study examines the relationship between audit committee characteristics and external auditors' characteristics (independent variables) and financial reporting quality (dependent variable). The study used a sample of firms from Bursa Malaysia, explicitly the top 100 performing firms according to the Bursa Malaysia stock exchange. The analysis of annual reports proves that audit committee (independence, expertise, and diligence) has the prediction capability to financial reporting quality. However, results indicate that industry leadership has significant impact on financial reporting quality, but on the other hand, large audit firms do not have any significant effect on financial reporting quality. This study adds to the knowledge of audit committee practices and procedures in accounting literature regarding the Malaysian context. The results of this study cannot be generalized because the study used the top 100 performing firms from Malaysia irrespective of particular industries. The results of this study might be changed if future researches use different sets of sample firms.

Keywords: Audit committee, external auditor, financial reporting quality, Discretionary Accruals

1. Introduction

It is generally believed that a fundamental pillar of capital markets is financial reporting quality because efficient resource allocation is determined by using such information. When the true performance of a firm is neither disclosed in the annual reports nor reflected in the reported earnings, then the economy, different companies, individual employees and investors can face huge losses (Pergola & Verreault, 2009). Similarly, the evidences of Schipper and Vincent (2003) claimed that stakeholders are very much concerned with financial reporting quality disclosed in annual reports because this information highly influences their decision making, specifically information related to investments and contracting.

It is generally argued that information about low and poor financial reporting quality leads to unintended transfer of wealth. The most important role that a corporate governance system plays is to closely monitor financial reporting and earnings quality of a firm (Cohen, Krishnamoorthy, & Wright, 2004). However, there is a significant relation between poor financial reporting quality and different mechanisms of corporate governance revealed by past studies that particularly discuss hot issues like manipulation, earnings management, flaws in internal control systems and financial statement frauds (Beasley, Carcello, Hermanson, & Lapedes, 2000; Beasley, 1996; Carcello & Neal, 2000; Dechow & Skinner, 2000; Klein, 2002; Krishnan, 2001). There are a remarkable number of studies that have been carried out to address the issues pertaining to the audit committee and external audit and their effect on financial reporting quality, but, these studies do not reach a conclusive finding related to the impact of audit committee and external auditor characteristics on financial reporting quality.

Agency theory addresses the conflict of interest between owners of the firm (principals) and firm managers (agents). Firm owners want to maximize their wealth because they have a high stake in the firm, whereas shareholders also want a high dividend and value maximization of their shares. These two objectives are opposite to each other and give rise to agency problem. Davis, Schoorman and Donaldson (1997), and Hamid, Othman, and Rahim (2015) argued that ineffective communication leads to the agency problem, also referred as information asymmetry between shareholders and managers. In contrast, some argued (e.g. Jensen and Meckling, 1976) that abusive use of powers by managers gives rise to the agency problem because most of the managers in firms try to take decisions in favour of their own interests instead the interests of all stakeholders. In line with the arguments of past studies such as (Bharath, Sunder, & Sunder, 2008; Dhaliwal, Naiker, & Navissi, 2010) 'accrual quality' is used as a proxy of financial reporting quality.

Several empirical research studies have provided evidence that the quality of a financial reporting system is highly dependent upon the mechanism of corporate governance, such as effectiveness of audit committee, external audit, financial expertise and board structure (Abbott, Parker, & Peters, 2004; Beasley, 1996; Farber, 2005; Klein, 2002; Vafeas, 2005).

The listing requirements of a stock exchange particularly support the establishment of audit committee and

the guidelines of several governance regulatory authorities give significant attention to audit committee and external audit. The mere presence of an audit committee in an organization is considered to be inadequate and is increasingly criticized, whereas the audit committee is more critical in achieving desired regulatory and oversight goals (Abbott, Parker, & Peters, 2012; Carcello, Hermanson, & Ye, 2011). Contrary to aforesaid arguments, this study by nature of being a significant internal control mechanism, provides empirical evidence on the role of audit committee and external audit characteristics in emerging economies like Malaysia, which has not been well addressed by past studies. The assessment of the external financial reporting system of a firm is still an empirical question and with background under auditing standard (PCAOB, 2007). External auditors can relay their work on internal auditors. These issues deteriorate quality of financial reporting and adversely affect the firm's reputation. Therefore, the relation between shareholders and managers should be scrutinized effectively (Zaitul, 2010).

Discussion about the audit committee is crucial to assure the credibility of financial statements examined by the stakeholders and used as a benchmark for making conclusive investment decisions. Therefore, the audit committee has the incentive to issue high quality reports. In addition, the audit committee is also expected to perform high quality audit work to maintain its reputation, increase the audit market and avoid legal liability. On the subject of reliance of audit committee and external auditor on the financial reporting quality, Bame-Aldred et al. (2012) argued that there are few studies that address the impact of reliance on financial reporting quality by external auditors to assure external audit quality.

The East Asian Financial Crisis of 1997 through significant attention and scrutiny by Malaysian public listed firms. Malaysian firms are required to establish audit controls and maintain a strong and effective system on internal controls in compliance with instructions given by the Malaysian Code of Corporate Governance (MCCG) in 2000. In case of non-existence of audit controls, boards will explain how regular and sufficient review and assurance would be undertaken on internal controls. Moreover, during 2001, an industry task force was established by securities commission of Malaysia to formulate instructions and guidelines for the establishment of audit compliance. Due to the increase in corporate irregularities, especially after the Asian Financial Crisis (such as Nasion Com Holding, Takaful Bhd, Megan Media Holdings, Transmile Group Bhd, and Southern Bank Bhd), the MCCG was revised twice, once in 2007 and again in 2012.

This research is confined to 100 Malaysian firms listed in Bursa Malaysia. This study is theoretically significant because it examines the relationship between audit committee and external auditor characteristics with financial reporting quality in a single framework. Malaysia introduced the IFRS system to improve the financial reporting system. In the context of Malaysia, this study contains the practical significance of the audit committee and external auditors of Malaysia and provides a transparent picture of the Malaysian business environment. Therefore, this study fills this gap by undertaking a comprehensive analysis of Malaysia. Specifically, this research intends to achieve following objectives:

- I. To determine the effect of audit committee characteristics such as independence, expertise and diligence on the financial reporting quality among Malaysian listed firms.
- II. To investigate the impact of external auditor large audit firms and external auditor industry leader on the financial reporting quality among Malaysian listed firms.

2. Literature Review

The quality of accounting information has become an important issue as a result of the revolution in modern information technology and associated business practices seen worldwide (Afify, 2009). Financial information quality has been approached empirically since the late 1960s. Studies have focused on ascertaining whether the data provided by companies are beneficial to accounting users. In the beginning, some studies investigated the content of the information (Ball & Brown, 1968). However, to focus on information relevancy, a new orientation was emerged in the late 1980s which uses robust regression models to explore the relationship between market profitability and financial information (Ou & Penman, 1989). These models exhibit the phenomena that financial information of corporate organizations must face certain changes, particularly introduction of International accounting practices.

So far, several studies have empirically examined the audit committee in relation to financial reporting quality. Based on previous experimental and survey based studies, Gramling et al. (2004) suggested that audit committee affects firm performance, corporate governance quality and financial reporting quality. However, to date, the relationship between financial reporting quality and audit committee is not well addressed by past studies except for Prawitt, particularly regarding how board of directors play a significant role in ensuring financial reporting quality. Previous studies stated that effectiveness, expertise and knowledge, independence and composition are those attributes of the board that significantly affect financial reporting quality, such as fraud, earnings quality and earning manipulation (Abbott et al., 2004; Farber, 2005).

Many studies highlight different aspects while discussing financial information quality, which open new research lines. As a result of the utilitarian paradigm, research on accounting took a new path in the late 1960s

and led to the adoption of a new accounting methodology which considers accounting as an information system. Accordingly, the line of capital markets research emerged. The focus of this approach is on the performance of accounting information for investors. In this research approach, Ball and Brown (1968); Beaver (1968) are deemed to be pioneers. Two fields in this approach can be easily distinguished:

- I. The investigation of the measurements of accounting results.
- II. To conduct research for the study of information, content and relevance.

As far as the examination of information is concerned, it is associated with the content of information. To be precise, in relation to publications of earning announcements, market response is widely investigated. Different authors indicate that, in relation to earnings announcements, market prices have positive reaction (Barth & So, 2014). In the study of Korean firms Bae, Cheon, and Kang (2008) found that the value of market shares are positively or negatively influenced by the increase or decrease in earnings announcements; but some studies provide contradictory results (Abarbanell & Park, 2016; Demerjian, Lev, Lewis, & McVay, 2012).

International Financial Reporting Standards (IFRS) are used to prepare consolidated financial accounts of listed companies (Jaggi, Allini, Rossi, & Caldarelli, 2016). To bring harmonization and introduce some changes in accounting, several measures were taken for the transparency of information disclosure that is deemed to be a key factor in producing quality accounting information (Epstein & Epstein, 2009). Thus, in explaining the true economic condition of a company, financial information quality plays a significant role. Several empirical studies provide evidence that quality of external financial reporting is particularly associated with corporate governance factors, such as effectiveness of audit committee, financial expertise, board size, CEO duality and board structure (Klein, 2002; Vafeas, 2005). Moreover, the agency theory is considered to be the main theory explaining the relationship among explanatory variables such as audit committee characteristics and financial reporting quality. Examining the agency theory itself was developed by Jensen and Meckling (1976), who argued that the agency problem can be reduced if the audit will provide quality service. Prior research studies such as the work of Guthrie et al., (2006); Whiting and Woodcock (2011) showed that agency theory has the direct and indirect link to the transparency of financial reporting quality.

3. Methodology

This study is an attempt to examine the relationship between audit committee characteristics: namely, independence, expertise, diligence, and external auditor characteristics namely, large audit firms, industry leader, and financial reporting quality for top 100 listed companies in Malaysia for the year 2014.

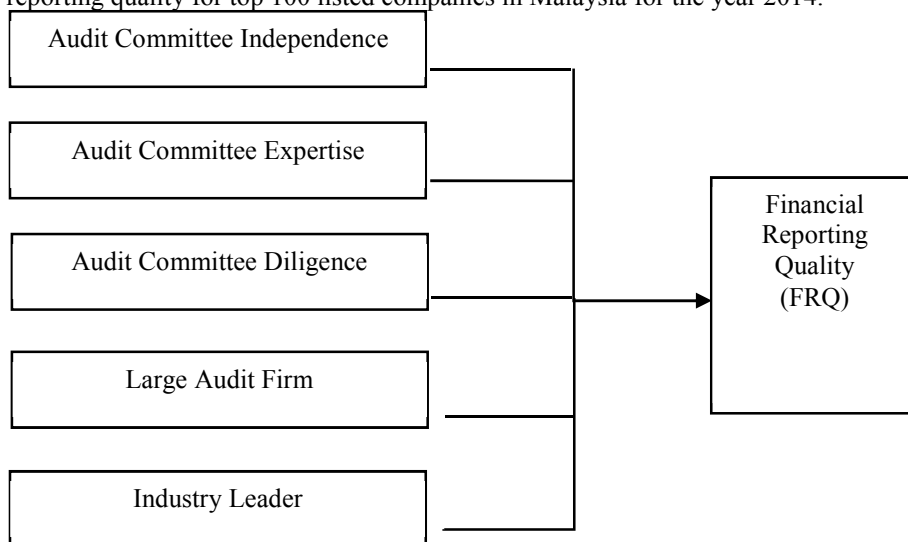


Figure 1: Conceptual Framework

3.1 Data Collection

The data for present research is collected from annual reports of the companies available on the websites of Bursa Malaysia or a firm's own website downloaded in pdf format for the year 2014. The stratified random sampling approach is used where different markets are used as strata. The data required for this study is related to audit committee characteristics, external auditor characteristics and financial reporting quality. Data for the independent variables are collected from audit committee reports section inside the annual report. Data for the dependent variable is taken manually from annual reports, particularly from the financial statement sections.

3.2 Model Specification and Operational Definitions of Variables

The relationship between financial reporting quality and audit committee independence, expertise, diligence, external auditor large audit firm, and industry leader is specified in Equation [3.1] below.

$$FRQ_{it} = \beta_{0it} + \beta_1 ACI_{it} + \beta_2 ACE_{it} + \beta_3 ACD_{it} + \beta_4 EALAF_{it} + \beta_5 EAIL_{it} + \epsilon_{it} \quad (3.1)$$

Where; FRQ represents financial reporting quality, ACI represents audit committee independence, ACE represents audit committee expertise, ACD represents audit committee diligence, EALAF represents external auditor large audit firm, EAIL represents external auditor industry leader and ϵ represents error term.

Financial reporting quality is measured by using absolute value of discretionary accruals to estimate the discretionary accruals, the modified-jones model (1999) was adapted, which is specified followed by Kothari, Leone and Wasley (2005).

$$TAC_{ijt} / A_{ijt-1} = \alpha_j (1/A_{ijt-1}) + \beta_{1j} [(\Delta REV_{ijt} - \Delta REC_{ijt}) / A_{ijt-1}] + \beta_{2j} (PPE_{ijt} / A_{ijt}) + ROA_{t-1} + \epsilon_{ijt-1} \quad (3.2)$$

Where;

TAC_{ijt} = Total accruals for firm i in industry j in the current year t ;

A_{ijt-1} = Total assets for firm i in industry j at the end of the previous year;

ΔREV_{ijt} = Change in revenue for firm i in industry j between the current year and last year;

ΔREC_{ijt} = Change in receivables for firm i in industry j between the current year and last year;

PPE_{ijt} = Gross property, plant and equipment for firm i in the current year; and

ROA_{t-1} = Return on assets at the end of the previous year.

Total accrual (TAC) are calculated as the difference between operating income (EARN) obtained from the financial statement and operating cash flow (CFO) obtained from the statement of cash flow.

$$TAC_{ijt} = EARN_{ijt} - CFO_{ijt} \quad (3.3)$$

The predicate value from equation [3.2] is non-discretionary accruals (NDAC), and the difference (residuals) between total accruals (TAC) and NDAC is discretionary accruals (DAC) (Kothari et al., 2005).

$$DAC_{ijt} = TAC_{ijt} - NDAC_{ijt} \quad (3.4)$$

3.3 Methods of Analysis

Descriptive analysis is carried out to examine the behaviour of variables. After descriptive analysis, correlation analysis is conducted to investigate mutual association among variables included in the analysis. In order to inspect the impact of audit committee characteristics and external auditor characteristics on financial reporting quality, the ordinary least square method is applied because the data is cross-sectional in nature and fulfils basic assumptions of the classical linear regression model.

4. Results and Discussion

This section details descriptive analysis of the collected data followed by the correlation and regression analysis on variables of interest. Regression analysis is presented in two separate models as the first model offers the calculation of non-discretionary accruals (NDAC) by the company, which is used to calculate the discretionary accruals (DAC) by subtracting that NDAC from total accruals (TAC). Next, regression results are presented in order to examine the relationship between financial reporting quality and selected explanatory variables.

4.1 Descriptive Analysis

Descriptive statistics are calculated for all the variables that include mean and standard deviation, maximum and minimum values of each variable for all the focus variables in table 4.1 below:

Table 4.1 *Descriptive Statistics*

	N	Mean	Standard Deviation	Maximum	Minimum
FRQ	100	5.0007	1.5824	9.2637	1.2508
ACI	100	0.8114	0.1779	1	0.34
ACE	100	0.4627	0.193	0.8	0
ACD	100	5.798	2.5434	18	2
EALAF	100	0.92	0.2727	1	0
EAIL	100	0.28	0.4513	1	0

FRQ: Financial Reporting Quality ACI: Audit Committee Independence, ACE: Audit Committee Expertise, ACD: Audit Committee Diligence, EALAF: External Auditor Large Audit Firm and EAIL: External Auditor Industry leader

The analysis reveals that the mean is 0.8114 for the audit committee independence in the top 100 companies in the Bursa Malaysia, which concludes that around 81% concentration has found independency in the audit committee structure in the form of independent executive directors at the top 100 performing companies in the Bursa Malaysia. The mean of audit committee diligence shows that on average six meetings held with a standard deviation of 2.54, which concludes that the top 100 companies of Malaysia conduct 3 to 6 meetings per year.

4.2 Correlation Analysis

Correlation analysis for the included explanatory and dependent variables is presented in table 4.2 below. It is revealed that the correlation between FRQ and ACI, ACE, ACD and EAIL is significant while the relationship between FRQ with EALAF is insignificant.

Table 4.2 *Correlation Analysis*

	FRQ	ACI	ACE	ACD	EALAF	EAIL
FRQ	1.000000					
ACI	0.037518*	1.000000				
ACE	0.171121**	-0.085417	1.000000			
ACD	0.161318*	-0.074910	0.019517**	1.000000		
EALAF	-0.045044	-0.174527	0.019466*	0.151181*	1.000000	
EAIL	0.177612*	-0.074439	-0.076014	0.070898*	0.186201	1.000000

FRQ: Financial Reporting Quality ACI: Audit Committee Independence, ACE: Audit Committee Expertise, ACD: Audit Committee Diligence, EALAF: External Auditor Large Audit Firm and EAIL: External Auditor Industry leader

* shows significance at 10 percent level of significance

** represents 5 percent level of significance

4.3 Regression Analysis

To estimate non-discretionary accruals (NDAC), following estimation is carried out:

Table 4.3 *Estimates of auxiliary regression estimating NDAC*

Dependent Variable: TAC_A

Method: Least Squares

Sample: 1 100

Included observations: 100

Variable	Coefficient	Std. Error	t-Statistic	P-Val
C	0.036914	0.042916	0.860141	0.3919
1/A	-129.4372	64.90928	-1.994124	0.0490
(Δ REV- Δ REC)/A	-2.999668	0.217593	-13.78571	0.0000
PPE/A	0.080234	0.034085	2.353967	0.0206
ROA _{t-1}	-0.032929	0.038352	-0.858598	0.3927
R-squared	0.814180	Mean dependent var		-0.157127
Adjusted R-squared	0.806356	S.D. dependent var		0.812997
S.E. of regression	0.357759	Akaike info criterion		0.830793
Sum squared resid	12.15920	Schwarz criterion		0.961051
Log likelihood	-36.53965	Hannan-Quinn criter.		0.883511
F-statistic	104.0621	Durbin-Watson stat		1.709231
Prob(F-statistic)	0.000000			

NDAC: Non-discretionary Accruals TAC: Total Accrual, A: Total Assets, Δ REV: Change in Revenue, Δ REC: Change in Receivables, PPE: Gross Property, Plant and Equipment, ROA: Return on Assets, ϵ : Error Term

The value of R-square in this estimation is 0.8141, which shows that more than 81% of the variations in non-discretionary accrual are explained by included independent variables in the model. In addition, this can be examined from significant F value. It is evident from the estimation that all the coefficients except for lagged ROA are statistically significant at 5% significance level as shown in table 4.3.

After estimating DAC from Eq. (3.4), absolute values of DAC and the resultant is taken as a proxy measure for the financial reporting quality. The FRQ depends upon audit committee independence, audit committee expertise, audit committee diligence, external auditor large audit firm and external auditor industrial leader and ϵ_t is the residual term fulfilling the CLRM assumptions as shown in Eq. (3.1) is as follows:

Table 4.4 *Estimates of regression estimating FRQ*

Variable	Coefficient	Std. Error	t-Statistic	P-Val
C	3.542951	1.141442	3.103927	0.0025
ACI	0.573362	0.265214	2.161884	0.0316
ACE	1.588973	0.833253	1.906953	0.0597
ACD	0.102271	0.063167	1.619058	0.0989
EALAF	-0.581905	0.600070	-0.969728	0.3348
EAIL	0.726537	0.362106	2.006423	0.0478
R-squared	0.802096	Mean dependent var		5.008395
Adjusted R-squared	0.770980	S.D. dependent var		1.604713
S.E. of regression	1.561807	Akaike info criterion		3.789423
Sum squared resid	221.9708	Schwarz criterion		3.948684
Log likelihood	-177.7870	Hannan-Quinn criter.		3.853820
F-statistic	3.069435	Durbin-Watson stat		1.920615
Prob(F-statistic)	0.026403			

FRQ: Financial Reporting Quality, C: Constant, ACI: Audit Committee Independence, ACE: Audit Committee Expertise, ACD: Audit Committee Diligence, EALAF: External Auditor Large Audit Firm and EAIL: External Auditor Industry leader

Table 4.4 above represents the estimation of regression model given in Eq. (3.1), where, FRQ is the dependent variable and ACE, ACD, EALAF, EAIL are the explanatory variables included in the model. This can explain model same as it is explained in case of auxiliary regression. The value of R^2 is 0.8021 which shows that more than 80% of the variations in FRQ are predicted by ACI, ACE, ACD, EALAF and EAIL. The result of R^2 is consistent with the findings of Madawaki (2012) who conducted same research on Nigeria and found that around 85% of variations in FRQ are explained by independent variables. It is evident that ACI and EAIL are significant at 5% significance level, whereas ACE and ACD are significant at 10% significance level but the influence of EALAF on FRQ is insignificant. Although prior research suggested that, significant relationship between the auditor (large audit firm, size, and characteristics) with financial statements (Becker et al., 1998). However, the findings of Wallace et al. (1994) are consistent with the present research. The overall model significance can also be observed from the significant value of F-statistic (0.0264) and it can be concluded that overall this model is fit for examining the variations in FRQ.

5. Conclusion

The examination of the top 100 Malaysian companies from Bursa Malaysia provides very interesting results as present research has provided mixed findings. The estimation results presented in the previous section indicates that all included explanatory variables except external auditor large audit firm (EALAF) have strong and significant influence on financial reporting quality. The study is unique and has novelty in the selection of variables. Past studies have provided evidence on the relationship between audit committee characteristics and financial reporting quality. In contrast, this study has taken the external role of auditors to support the argument that the external auditors' role also influences financial reporting quality. The observation of large audit firms has concluded by the detailed examination of discretionary accruals, which was the proxy of financial reporting quality. As per findings of previous researches, big4 audit firms had a significant relationship with financial reporting quality. Along with different contributions of this study, there are number of limitations. Based on the results and findings, this study suggests that future research needs to overcome its limitations and provide more insight. The present study tested the effect of some factors on financial reporting quality hence, future studies are suggested to incorporate more factors to provide deeper insights into how effectively additional factors influence financial reporting quality in the Malaysian context. Therefore, it is suggested that the same methodology can be used by future studies for other countries where this relationship is yet not tested. It is also suggested that future research can extend these findings by increasing the number of sample companies if more annual reports are available. Future study can also adopt different models of measuring and estimating the influence on financial reporting quality or combine the use of models as in other studies which will allow comparison of the present results. Additionally, future study might examine the relationship between size of the audit committee and the

external auditor's audit committee tenure with relation to financial reporting quality.

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