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International Conference on Accounting Studies (ICAS) 2016
15-18August 2016, Langkawi, Kedah, Malaysia

Audit Committee Independence, Financial Expertise and Financial Restatements

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Abstract

This study examines the effect of audit committee characteristics namely audit committee independence, accounting background of the audit committee chairman and financial expertise of audit committee members on the financial restatements of the public listed companies in Malaysia. Previous studies that investigated the relationship between audit committee characteristics and financial restatements were done in foreign countries. Therefore, this study contributes to the literature in this field of study in Malaysia. This study utilizes the annual reports for the fiscal year 2014. By using the logistic regression analysis, the result shows that there is a negative significant relationship between the audit committee independence and financial restatements. However, with regards the results for the accounting background of the chairman of audit committee and the financial expertise of audit committee members reveal that the relationship are not statistically significant. Further analyses are also carried out in order to examine the robustness of the relationship between audit committee characteristics and financial restatements. Also, this study discusses the implications and recommendations.

Keywords: Financial restatements, audit committee independence, audit committee chairman, financial expertise

1. INTRODUCTION

Financial restatements issue has received considerable attention from the regulators in Malaysia. In 2007, cases involving The Maxbiz Corp, Transmile and Megan Media Holdings signaled accounting irregularities cases in Malaysia. As the financial restatements issue affects the investors' confidence in Malaysia companies, therefore it should be addressed. According to Abbott, Parker & Peters, (2010), audit committee is seen as an independent body to an organization that provides the assurance that the company is practicing good governance to the external parties. The audit committee liaises much with the external and internal auditors (Abbott et al., 2010), as these two parties are the frontlines to ensure that good governance practices are in place, thus the likelihood of errors in the financial statement is reduced.

In Malaysia, all public listed companies are required to have an audit committee with a minimum of three members, with a majority of independent directors. Beside audit committee independence, the draft of Malaysian Code on Corporate Governance 2016 specifies that the audit committee chairman should have accounting expertise or relevant work experience. It is important for the audit committee chairman to be able to lead discussions and deliberations and ultimately be satisfied that the end result fairly reflects the understanding of the audit committee. Thus, audit committee chairman with accounting background should be appointed in

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order to ensure high quality of financial reporting as they have the expertise, knowledge and relevant skills. Furthermore, the main objective of mandatorily requiring a member with accounting expertise to be appointed to the audit committee is to make sure that the committee can rely on this said director for experts advised relating to financial and accounting matters, subsequently prevent any financial restatements.

2. LITERATURE REVIEW

2.1 Financial restatements

Prior studies have provided evidence of numerous motivations that drives managers towards financial restatements, for instance the quality of accounting figures (Davidson, Jiraporn, Kim, & Nemac, 2004), distribution of company's ownership (Hsu & Koh, 2005), CEO duality in which two leadership positions are held (Davidson et al., 2004), adoption of International Financial Reporting Standards (IFRS) (Tendeloo & Vanstraelen, 2005), tax incentives (Dhaliwal, Gleason, & Mills, 2004) and the hiring of senior executives from the company's external accounting companies (Geiger, North, & O'Connell, 2005). These studies have pointed out that financial restatements practices are hiding the truth of the company's actual value and eventually shareholders' or stakeholders 'interest will deteriorate.

The practice of financial restatements poses severe threats to a company as upon discovery of such practices, investor's confidence in the financial reporting function of the company can erode, and it impedes the efficient flow of capital in the financial market (Jackson & Pitman, 2001). The reliability of the reported earnings is tarnished as the figures do not reflect the actual performance of the company. In the past, several high profile audit failures have prompted international investigations into the issue of financial restatements (Arya, Glover, & Sunder, 2003).

2.2 Financial restatement and audit committee independence

An independent audit committee is crucial to perform its financial reporting oversight. The more independent the audit committee is, the more it can perform financial reporting oversight effectively, and as the audit committee is not influenced by the management.

Thus, the objectivity is ensured if there is independence in the committee (Kolins, Cangemi, & Tomasko, 1991). Furthermore, as independent directors usually serve as directors in other public companies, and therefore care about their reputation, they will discharge their duties more diligently (Nguyen &Nielsen, 2010). This is supported by the Cornett, Marcus, & Tehranian (2008), who found that independent directors bring a greater wealth of experience to the companies as they are eager to build a reputation in the market through monitoring performance.

It can be concluded that an audit committee is fully independent when all members of the committee comprise of independent non-executive directors. The common expectation that an independent board would ensure more reliable financial reporting is supported by Abbott, Park, & Parker (2000); and Beasley, Carcello, Hermanson, & Lapides (2000). Moreover, Cornett et al. (2008) found that independence of directors has a negative association with financial restatements activity by large banks in the United States. Further, Dimitropoulos & Asteriou (2010) concluded that there is a strong relationship between independence of directors with improved financial performance and a lesser use of financial restatements. Thus, it is expected that the audit committee independence has a negative relationship with the financial restatements.

2.3 Financial restatement and accounting background of the audit committee chairman

As a member of the audit committee, one is expected to be able to ask tough and probing questions to ensure that the management is faithfully representing the activities of the companies (Spira, 2003). The presence of a member with financial expertise in the committee adds value to the shareholders of the companies in respect of technical accounting issues. Therefore, a person with accounting expertise or relevant work experience should be appointed as the chairman of the audit committee as specifies by the draft of Malaysian Code on Corporate Governance 2016.

It is important for the chairman to be able to lead discussions and deliberations and ultimately be satisfied that the result fairly reflects the understanding of the audit committee. As many of the audit committee's duties are involved with financial aspects, the chairman of audit committee needs to be someone who is financially sound. Thus, audit committee chairman with accounting background should be appointed in order to increase the quality of financial reporting. It is expected that the extent to which accounting background of the audit committee chairman is negatively associated with the incident of financial restatements.

2.4 Financial restatement and financial expertise of audit committee members

At least one of the audit committee members should be a member of an accounting organization and should be financially educated as specifies by the Malaysian Code on Corporate Governance (Revised 2007). Audit committee plays an important role in ensuring the integrity of the financial reporting, hence the audit committee should be able analyze and understand financial statements so that they can effectively fulfill their duties.

A financially literate team of audit committee should garner more trust on the part of shareholders as the latter will perceive the financial reports and in particular the earnings figures reported as more reliable and less likely to produce erroneous financial reports, be it quarterly reports or year-end financial statements, when the audit committee team is financially literate. For example, Carcello & Neal (2003) found that financial literacy of audit committee members is indeed proxy to the integrity of annual financial statements. Moreover, Abbott, Paker & Peters (2004) reported a negative relationship between the audit committee's financial expertise and occurrence of financial restatement.

The main objective of mandatory requirement of a member with accounting expertise to be appointed as the audit committee member is to make sure that the committee can rely on this said director for experts advised relating to financial and accounting matters. Thus, when the audit committees are staffed with more members with finance or accounting expertise, theoretically it should be able to prevent financial restatements. Thus, it is expected that financial expertise of audit committee members is negatively related with the financial restatements.

3. RESEARCH METHODOLOGY

3.1 Sample selection

The sample is selected based on the annual reports for the year 2014 as this is the latest information available. Furthermore, this study seeks to determine whether there are any differences between the most recent findings as compared to those conducted several years ago in Malaysia such as research done by Abdullah, Mohamad Yusof & Mohamad Nor, (2010) and Abdul Wahab, Willie & Nik Abdul Majid with other jurisdictions around the world.

The sample companies consist of the non-financial public listed companies in Malaysia that made amendments to their financial reports in 2013 which is identified through annual report for the fiscal year 2014. This procedure is similar to the procedure followed by Abdullah et al. (2010) and Abdul Wahab et al. (2014) (2014). The companies are selected by screening the annual reports of more than 800 public listed companies in Malaysia. The details are obtained from www.bursamalaysia.com. These companies are then screened for the availability of the necessary financial information. The final sample excludes the companies which financial information is not completely available and companies that were delisted.

The sample of companies which has restated its financial results is identified using the keywords, "restate," "restated," "restatement" and "prior year adjustment" in the annual report as based on the United States Government Accountability Office (GAO) definition. This procedure is similar to the procedure followed by Abdullah et al. (2010). These restatements sample are then matched with a non-restatements sample, also known as a control sample, based on the industry involved and company's size (total assets). The total assets of the control sample can be varied by 10 percent and varied by no more than 20 percent at the most (Minutti-Meza 2011). The control sample is then screened for the absence of amendments in financial statements report.

3.2 Data analysis and model specification

The final sample consists of 34 public listed companies that restated their financial statements and 34 control samples amounted to 68 companies. Data obtained are analyzed using STATA version 13 and Statistical Package for Social Sciences (SPSS) version 24, which are the statistical tools commonly used for accounting research. In order to examine the relationship of the audit committee characteristics (audit committee independence, the accounting background of audit committee chairman and financial expertise of audit committee members) and financial restatements, this study follows a well-established model used by Abdullah et al. (2010) and Abdul Wahab et al. (2014). The model is as follows:

RESTATE (0, 1) = $\beta_0 + \beta_1 INDTAC + \beta_2 ACCCHAIR + \beta_3 FINEXP + \beta_4 LOGASSETS + \beta_5 DEBT\_EQ + \beta_6 LOSS + \beta_7 BIG\_4 + \varepsilon$

Where,

Dependent Variable

RESTATE	=	The company that restated its financial statements for the year 2013 (Based on GAO definition).

Independent Variables

INDTAC	=	The number of independence audit committee in term of fraction over total of audit committee members
ACCCHAIR	=	Accounting background of the chairman of audit committee
FINEXP	=	The number of financial expertise of the audit committee members

Control Variables

LOGASSETS	=	The natural log transformation of total assets
DEBT_EQ	=	The ration of total debt to total equity
LOSS	=	If the company recorded loss during the year
BIG_4	=	If the company is audited by the big 4 auditing firms (PricewaterhouseCoopers, Deloitte Touche Tohmatsu Limited, Ernst & Young and Klynveld Peat Marwick Goerdeler (KPMG))
ε	=	Error term
$\beta 0$	=	constant (i = 0), regression coefficients (i =1, 2, 3,…,7)

4. RESULTS AND DISCUSSIONS

4.1 Descriptive statistics

Table 1 shows the descriptive statistics related to the mean, standard deviation, minimum, and maximum. It represents all variables including the dependent variable which is companies that restated the financial report (RESTATED), the independent variables that consists of the number of independence audit committee member in term of fraction over total of audit committee members (INDTAC), accounting background of the chairman of audit committee (ACCCHAIR) and members of audit committee who have the accounting and financial background (FINEXP).

The control variables used are the natural log transformation of total assets (LOGASSETS), debt to equity ratio (DEBT_EQ), if the company recorded loss during the year (LOSS) and if the company is audited by the Big Four auditing firms (BIG_4).

Table 1. Descriptive statistics

VARIABLES	MEAN	STD.DEV.	MIN	MAX
RESTATED	0.5	0.504	0	1
INDTAC	0.901	0.149	0.5	1
ACCCHAIR	0.721	0.452	0	1
FINEXP	1.676	0.679	1	3
LOGASSETS	13.318	1.624	10.884	17.595
DEBT_EQ	0.552	0.702	.003	3.394
LOSS	0.235	0.427	0	1
BIG_4	0.471	0.503	0	1

Based on Table 1 from the total observation of 68 companies, the mean score for RESTATED is 0.5 with the standard deviation of 0.5037. The minimum value for restated is 0, and the maximum value is 1. This indicates that equal numbers of restated and non-restated companies are observed. The minimum and a maximum number of independence audit committee member in term of the fraction are 0.5 and 1 show that the majority of audit committee members consist of an independence director.

The mean for accounting background of the audit committee chairman (ACCCHAIR) is 0.721. The result also shows that the mean of the audit committee members who have the accounting and financial background (FINEXP) is 1.676. The minimum number of the audit committee with the accounting and financial background is 1 and 3 as the maximum number of the audit committee who has the financial background. This is coherent with the requirements as prescribed or approved by Bursa Malaysia which stated that the committee shall include at least one member who must be a member of the Malaysian Institute of Accountants (MIA) or if he/she is not a member of the MIA, he must have at least three (3) years working experience in accounting field.

4.2 Logistic regression results

After all linearity assumptions are satisfied, the logistic regression analysis is utilized to examine the relationships of audit committee independence, accounting the background of the audit committee chairman and the existence of accounting and financial expert within the audit committee on the occurrence of financial restatements.

Table 2 shows the independent variables which consist of the number of independent audit committee members in term of a fraction of a total of audit committee members (INDTAC), and a control variable, namely debt to equity ratio (DEBT_EQ), are significant predictors of dependent variable (RESTATED). Specifically, independent variable of INDTAC has a negative relationship with the dependent variable (RESTATED).

On the other hand, accounting background of the audit committee chairman (ACCCHAIR), members of audit committee who have the accounting and financial background (FINEXP), and the control variables which are the natural log transformation of total assets (LOGASSETS), if the company recorded loss (LOSS) and if it is audited by the Big Four auditing firms (BIG_4), are statistically insignificant with the dependent variable (RESTATED).

Table 2. Logistic regression results

Variables	Expected Direction	Standardized Coefficients Beta	t-value	Sig.
INDTAC	-	-6.749	-2.68	0.007***
ACCCHAIR	-	0.039	0.05	0.962
FINEXP	-	0.053	0.11	0.913
LOGASSETS	-	-0.092	-0.39	0.693
DEBT_EQ	+	1.720	2.60	0.009***
LOSS	+	0.938	1.25	0.213
BIG_4	-	-0.416	-0.55	0.582
Wald Chi^2				18.20
Prob > Chi^2				0.011
Pseudo R^2				0.315
Overall percentage of correct prediction				75.00%

Notes: Significant at 0.10 (one – tailed)*
Significant at 0.05 (one – tailed)**
Significant at 0.01 (one – tailed)***

4.3 Further analyses

Further analyses are carried out in order to examine whether the main results are sensitive to different measurements. Two different measurements are employed for audit committee independence. First is the value of one if all members are independence audit committee members and zero otherwise. Second is the absolute number of the independent audit committee members.

The results from further analyses support the main findings, which mean that there is a negative relationship between the audit committee independence and financial restatements. This finding is consistent with Abbott et.al. (2000); and Dimitropoulos & Asteriou (2010), who found that independence of directors has a negative association with financial restatements activity. Also, the findings from this study consistent with the two previous studies in Malaysia (see Abdullah et al., 2010; and Abdul Wahab et al., 2014). These studies found that the audit committee independence has a significant relationship with financial restatements. However, with regards, the results for the accounting background of the audit committee chairman and the financial expertise of audit committee members show that both variables are not statistically significant with financial restatements.

These findings indicate that there is no relationship between the financial expertise of audit committee members and financial restatements. Thus, the findings support Johari, Saleh, Jaafar & Hassan (2008) and Lin, Li and Yang (2006) but contradict with that of Abbott et al. (2004) and Carcello and Neal (2003). The reasons behind these findings might be because of the audit committee members do not have any access or provided with sufficient information, in particular on the financial matters of the company. Therefore, the audit committees are unable to assess the financial condition comprehensively.

5. IMPLICATIONS AND CONCLUSIONS

The findings from this study contribute to the literature on the relationship between audit committee characteristics and financial restatements. In particular, the audit committee independence, accounting background of the audit committee chairman and financial expertise of the audit committee members. This study provides evidence on audit committee independence which proved to have a significant relationship with financial statement restatements. The relationship is negative, means that when there are more independence members sitting on the audit committee, the chances of occurrence of financial restatements are reduced.

Based on published articles, this study can be considered as the first study to examine the relationship between the accounting background of the audit committee chairman and financial restatements. This is because the draft of Malaysian Code on Corporate Governance 2016 specifies that a person with accounting expertise or relevant work experience should be appointed as the chairman of audit committee. Therefore, it is expected that the findings of this study can contribute to making recommendations for good corporate governance practices by providing more valuable information to the accounting regulators in Malaysia.

ACKNOWLEDGEMENTS

The authors would like to express their gratitude to Universiti Utara Malaysia for facilitating this research.

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