THE EFFECTIVENESS OF AUDIT COMMITTEE IN RELATION TO FINANCIAL REPORTING FRAUD

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ABSTRACT

The objective of this study is to examine the relationship between audit committee attributes (audit committee independent, expertise, meeting, gender and ethnicity) and the propensity of fraudulent financial reporting. The sample includes 116 frauds and non-fraud companies listed on Bursa Malaysia from the year 2005 to 2010. This finding of this study indicates that the audit committee independent is positively associated with fraudulent financial reporting. The higher proportion of independent or outside director in the committee, the higher the propensity of financial fraud occurrence. The results also show that, the audit committee expertise is negatively associated with the corporate fraud. This suggests that when audit committee members are financially literate, they are more competent to curb fraudulent financial reporting. However, the finding for audit committee meeting, gender and ethnicity show that there is no relationship between these variables with the corporate fraud. The result of this study is robust after controlling for other firm-specific effects.

***Keywords**: audit committee independent, financial literacy, fraudulent financial reporting.*

1. Introduction

Corporate fraud is an unresolved issue that faced by many organizations in global. The evolution of economies conditions grant many opportunities for corporate fraud to occur. The aims of management are to achieve more wealth to the shareholders by an emphasis on high profits as well as to boost up the share prices. By doing so, they are not only serving to the shareholders but also to their personal benefit as well. This led to the management being pressure to achieve these objectives and one of the resorts is they tempt to engages in fraud when there are an opportunities to do so by expropriate the company wealth. Financial statement that materially misstated by management is due to the unethical behavior conduct by them which they have the intention to do this (Kalbers, 2009).

Financial information provides by the company is the medium of communication to the user about the firm performance for a recent year. User of financial statement such as a financial analyst and the investor will depend on the financial information provided by the company to make a decision even though the information provided involve fraudulent information (Tillman, 2009).

A board of directors must efficiently and independently in performing their duties especially in monitoring the organization activities on behalf of the shareholders and also investors. Moreover, the board also responsible to tone down the conflicts of interest between the owner and agents that are the management of the organization. Fama and Jensen (1983) stated that duties of the boards are to oversee the effectiveness of management in order to maximize the shareholders wealth and to avoid any activities that will damage the company performance. A shareholder is the owner of the company that has the authority to monitor the activities and planning of the organization as well as the rights to access the business financial condition (Zainal Abidin & Ahmad, 2007).

The revised Malaysian Code of Corporate Governance (MCCG) 2007 emphasizes on the role and responsibilities board of directors and also require the board to ascertain audit committee. Audit committee responsibilities in a company are to battle against corporate financial fraud. The audit committee plays an important role to oversight the financial matters of a company because it is a deal with firm values. Thus any opportunities will be taken by the management to engage in manipulation of earnings or misappropriation of assets in order to enhance greater value of the firm. Baucus and Near (1991) document that in this competitive advantage era and the transformation of economics condition, firms are exposed to the opportunity to engaged in fraud due to the changing of rules.

The audit committee in a company should comprise of independent and non-executive directors that shall form at least three committee members. Besides that, the board also clarifies to the audit committee regarding their duties and authority by providing to the committee the term of reference. An independent audit committee member that appointed by the board is someone who has no personal or financial relationships with the company and its top executives. The organizations that has fully independent audit are able to reduce the manipulation of earnings (Saleh, Iskandar and Rahmat, 2007). The independent audit committee ethically conducts their duties in order to prevent any misconduct by the top executives in the organization (Persons, 2009). The MCCG also highlighted that at least one of the committee members must expert in financial matters. Audit committee member that consists of financial expertise are able to execute better in the organization (Rahmat, Iskandar and Saleh, 2009). The independent audit committee with financial expertise enhances and improves the quality of financial disclosure (Felo and Solieri, 2009). In addition to that, audit committees also require to frequently carrying out meeting with external auditors. Liu and Zhuang (2011) highlighted in their study that using data from the year 1998 to 2005 find that, audit committee meeting that held by the organization under study is minimum four times a year. The audit committee of the larger firm tend to held meeting more frequent than smaller firm (Yin, Gao, Li and Lv, 2012).

The evolution of global challenges, the demand for female function in the board is increasing needed. The nature of the female attitude is more due care in performing the task and risk averse that every action must be taking into account the cost and effect. Audit committees that have at least one female director function in a different way than all male audit committees where the female director has more frequency of meeting than male director and more assiduous in their duty (Huang and Thiruvardi, 2010).

Malaysian has a unique culture where there consist of many ethnicity. It consists of Malay, Chinese, Indian, and others. Normally, these different races are a group into two categories that classified as Bumiputra or Malay and non-Bumiputra (Chinese, Indian and others). According to Haniffa and Cooke (2002), Malay director in Chinese firm have high voluntary disclosure and a smaller number of earnings manipulation. Family firm form the most of the company listed in Malaysia that has differential style, culture and tradition. (Claessens, Djannklov and Lang, 2000). The personal behavior of Bumiputra directors seen to give no effect in mitigating the manipulation of earnings because the increase in Bumiputra director increase the ownership and the director become more individualistic as similar to Chinese director (Rahman and Ali, 2006). The main objective of this study is to examine the audit committee attributes and propensity of corporate fraud.

2. Literature Review

The scandal in accounting arise because of the unethical behavior such as intentionally in misallocation of assets and financial misrepresentation meanwhile fraud of corporate executive involve accusation of unethical behavior in a company (Choo and Tan, 2009). High profile corporate scandals has seriously shocked the corporate world and shaken the confident of shareholders and stakeholders towards the integrity and responsibilities of corporate governance (Huang and Thiruvadi, 2010). In order to instill the confidence of investors in the capital market, effectiveness of corporate governance is required in monitoring the process of corporate financial reporting (Chang and Sun, 2010). The existence of effective audit committee in a firm will benefits the firm by having monitoring on the financial reporting and avoid corporate fraud (Rupley, Almer & Philbrick, 2011) but the more audit committee that expert in accounting will not reduce the asset misappropriation by a public company (Mustaffa and Youssef, 2010). The presence of independent audit committee in an organization reduces the earnings misappropriation in the organization (Klein, 2002).

Financial reporting be more quality if the audit committee emphasize more their role oversight the process (Mohamad-Nor, Shafie and Wan-Hussin, 2010). The audit committees roles are to ensure that the quality and accuracy of financial reporting and thus help management to prevent fraud (Steven and Mason-Olsen, 2007). Afify (2009) stated that the presence of the audit committee and has a good communication between management and external auditors enhance the financial reporting quality and timeliness.

An independent audit committee consists of outsider that independent from the company and management that enhance the committee to perform their duties. Abbott, Parker and Peters (2004) document evidence on their study that the existence of the independent board of directors in audit committee reduce the likelihood of manipulation of earnings in the firm. The independent audit committee has a negative association with the fraudulent financial reporting hence the high proportion of the audit committee lead to the low financial reporting fraud (Beasley, 1996). The presence of independent audit committee is significant caused the firm misstated their financial position (Abdullah, Mohamad Yusof and Mohamad Nor, 2010). Moreover, the firm that consist all independent audit committee will not prevent fraudulent financial reporting in the company (Owens-Jackson, Robinson and Shelton, 2009). Lin, Li and Yang (2006) find no relationship between audit committee independent and the manipulation of earnings. The financial expertise in the committee can oversight their role in preventing financial fraud (Huang and Thiruvardi, 2010). Audit committee that has financial and accounting knowledge enhance company to have better performance and help company to prevent fraud and financial distress situation (Rahmat et. al, 2009). Additionally, if the company has a high proportion of financial literate in audit committee, the likelihood of fraudulent misstatement is low (Mustafa and Youssef, 2010). Lin et al. (2006) finds that there is insignificant relationship between fraudulent reporting and financial expertise in the committee. The presence of financial expertise in the audit committee of a firm in post SOX period will not reduce the manipulation of earnings activities (Ghosh, Marra and Moon, 2010). Meeting held by the audit committee at least four times a year is positively related to the accuracy of earnings forecast (Liu and Zhuang, 2011). Farbers (2005) indicate that, the firm involve in fraud have weak governance and low audit committee meeting. In order to provide effective supervision on financial information disclose, the committee need to have more frequent meeting (Rahmat et al., 2009). The effectiveness of the audit committee has a positive relationship with the frequency of the meeting held (Collier and

Gregory, 1999). The more number of meetings will reduce the aggressiveness of the increasing manipulation of earnings (Kang et al., 2011). On the contrary, the frequent meeting by the audit committee enhances the earnings manipulation in the firm (Saleh et al., 2007). The current study by Chandresegaram, Rahimmansa, Rahman, Abdullah and Nik Mat (2013) find that the numbers of the meeting has no association with the degree of manipulation of earnings.

Recent trend show that the presence of female in the committee is increasingly important in the corporate world. The presence of women in the boards to enhance the business run healthily and consider as a complement to the male directors. Female is more ethical in performing their duties especially those who do not have experience than those in employment (Bilic and Sustic, 2011). In order to reduce the corporate fraud, the firm needs to increase the existence of female in the committee (Burgess and Tharenou, 2002). The cultural values are important factors especially in order to understand the belief and behaviour of an individual. The increase in ownership structure and the involvement of Bumiputera in the firm lead to the individualistic behavior in Malays. Additionally, the races of the directors give no impact to the manipulation of earnings (Rahman and Ali, 2006). Furthermore, Haniffa and Cooke (2002) in their study show that individualistic behavoiur is more on the Chinese counterpart as compared to Malays. In Malaysian, Malays considered as having low individualism that they are comfortable to works with others that has same beliefs, behavior and races. Malays also have high uncertainty avoidance as compared to Chinese (Salleh, Stewart and Whisenant, 2006). There is a difference in the monitoring system where the ethnic dominance of board composition and listed company (Yatim et al., 2006).

3. Hypotheses development

Companies listed under Bursa Malaysia are required to have the audit committee that consists of independent non-executive director. The audit committees that comprise of all independent committee reduce the earnings manipulation by the firm (Saleh et. al., 2007). The independent audit committee has a negative association with the fraudulent financial reporting hence the high proportion of the audit committee led to the low financial reporting fraud (Beasley, 1996). Therefore, the hypothesis is there is a negative relationship between audit committee independent and corporate fraud. A person that has a background of accounting and financial literate and has working experience in corporate finance is considering as having financial expertise (Agrawal and Chadha, 2005). The financial expertise in the committee can oversight their role in preventing financial fraud (Huang and Thiruvardi, 2010). Additionally, if the company has a high proportion of financial literate in audit committee, the likelihood of fraudulent misstatement is low (Mustafa and Youssef, 2010). Thus, the second hypothesis is there is a negative relationship between audit committee expertise and corporate fraud. The effectiveness of audit committees can be assess through the frequency of meeting and the committee must held four meetings a year as required by

MCCG. Abbott et al, (2004) posit that the meeting by the audit committee at least four times meet in a year enhances low restatement of financial reporting. However, Farbers (2005) indicate that, the firm that involve in fraud have weak governance and low audit committee meeting. The third hypothesis is there is a negative relationship between audit committee meeting and corporate fraud. Different gender persuades different attitude and ethical conduct in performing their duties. Female is more ethical in performing their duties especially those who do not have experience than those in employment (Bilic and Sustic, 2011). The gender diversity show that man in the management overconfident than women thus the tendency to commit fraud is higher than women are but the evidence is very limited in relation between fraud and gender (Schrand and Zechman, 2011). Thus, this lead to the next hypothesis is there is a relationship between female in audit committee and corporate fraud. The cultural effects also consider important especially in Malaysian have many races that act as important players in the industries. Additionally, the races of the directors give no impact to the manipulation of earnings (Rahman and Ali, 2006). Malays is considered as having low individualism that they are comfortable to works with others that has same beliefs, behavior and races. There is the difference in the monitoring system where the ethnic dominance of board composition and listed company (Yatim et al., 2006). The last hypothesis is there is a relationship between audit committee ethnicity and corporate fraud.

4. Research Design

Data collected through Securities Commission for the company that involved in fraud for six years starting from 2005 to 2010. Besides that, the data of the non-fraud firm that has been match to the fraud firm in order to ensure similar comparison. The annual reports of fraud and non-fraud companies gathered from the website of Bursa Malaysia. The actual data of 116 companies selected after all the data had been collected and companies with incomplete data have been deleted. The sample matched between fraud and non-fraud firm comprising 58 frauds and 58 non-fraud firm. The companies from the financial industry excluded due to the different in the rules and regulation as well as the nature of the business. The companies selected listed in the main board and ace market in the Bursa Malaysia.

The sample of fraud companies selected according to the revelations of fraud and lawsuits when the companies violate the rules and regulation of Securities Commission and Bursa Malaysia (Kamarudin et al., 2012). In meanwhile, the non-fraud firm will also chosen by matching the total assets of the companies. Audit committee independent (ACIND) is one of the independent variables in this study. Thus, this study measure audit committee independent using the percentage of independent non-executive directors to the total number of the audit committee members (Hashim and Abdul Rahman, 2011). This study measured audit committee expert as the percentage of the audit committee that is financial expertise such as a member of MIA or Chartered Accountant to the number of directors in audit committee (Mohamed Yunos et al., 2012). The measurement of the audit committee meeting by the number of the meeting held during the financial year (Yin et al., 2012). The data for gender diversity (ACGEN) acquire by review all the related annual report and identify the name of the director or via the photo of the directors if available in the report. In addition, obtain data by searched for gender identifiers such as "Miss", "she" or "her". The study using dummy variables indicate that the presence of female in audit committee is equal to 1 otherwise is 0. Thiruvadi (2012). Ethnicity in the audit committee (ACEC) using the ratio of Malay directors over total directors on the audit committee as their measurement of ethnicity Abdul Rahman and Mohamed Ali (2006). Further, the study also includes control variables (firm size, leverage and performance). The regression model of this study is as follows:

$$CF = \beta0 + \beta1ACIND + \beta2ACEXP + \beta3ACMEET + \beta4A + \beta5ACEC + \beta6SIZE + \beta7LEV + \beta8PER + \varepsilon$$

where, CF is corporate fraud, dummy variables, 1 if the firm that disclosed fraud and lawsuit cases in the earlier year and 0 otherwise. β0 is intercept coefficient, when all other independent variables are zero. ACIND is the percentage of independent non-executive directors to the total number of the audit committee members. ACEXP is the percentage of the audit committee that is financial expertise to the number of directors in audit committee. ACMEET is the number of the meeting held during the financial year. ACGEN is dummy variable, 1 if female presence in audit committee and 0 is otherwise. ACEC is proportion of Malays directors to total directors in audit committee. SIZE is Log10 of total assets. LEV is Log 10 Total debts over total assets. PER is dummy variable, 1 if the company has positive profit after tax, 0 is otherwise, and Ɛ is an error term.

5. Finding

Table 5.1 presented the frequencies of fraud and non-fraud firm according to the industries. The industrial product and trading and services industry have the highest percentage in both of the firm that is 25.9%. The hotel, infrastructure project company and plantation industry appear to be the lowest percentages of frequency that is 1.7%. Additionally, the highest companies commit fraud is in 2006 to 2008. The lowest percentage is in the year 2010.

Table 5.1: Frequencies Analysis by Industry and Year

Industry	**Fraud Firm (N=58)**		**Non Fraud Firm (N=58)**	
	Frequency	Percent (%)	Frequency	Percent (%)
Construction	6	10.3	6	10.3
Consumer Product	9	15.5	9	15.5
Hotels	1	1.7	1	1.7
Industrial Product	15	25.9	15	25.9
Infrastructure Project Company	1	1.7	1	1.7
Plantation	1	1.7	1	1.7
Property	8	13.8	8	13.8
Trading and Services	15	25.9	15	25.9
Technology	2	3.4	2	3.4
Y2005	4	6.9	4	6.9
Y2006	15	25.9	15	25.9
Y2007	14	24.1	14	24.1
Y2008	12	20.7	12	20.7
Y2009	10	17.2	10	17.2
Y2010	3	5.2	3	5.2

The result of table 5.2 presented the linear regression test on the model. Then, the result generates by adding the control variables. Additionally, the result generated also controls by industry and year. The R^2 indicates that the independent variables tested are 8%. However, after the result is control by industry and year, it shows that the variables tested are 45.3% of variation in corporate fraud explained by independent variables. The controls variables added improve the result of $R^{2.}$ The Hosmer and Lemeshow test show improvement in value when the controls variables added to the test. The result indicates that the Hosmer and Lemeshow value are more than 0.05 that is 0.448. This implies that the model's estimates fit the data at an acceptable level, and there is goodness of fit the regression model.

Table 5.2: Linear Regression Analysis (Independent Variables (IV), Control Variables, Control by Industry (I) and Year(Y))

	IV		Control Variables		Control by I and Y	
	Coeff.	Sig.	Coeff.	Sig.	Coeff	Sig.
Constant	-.167	.871	-3.019	.432	1.610	.779
AC IND	1.033	.019**	1.264	.013**	1.447	.014**
AC EXP	-1.366	.278	-1.937	.228	-3.289	.068*
AC MEET	.066	.669	.058	.756	.103	.624
AC GEN	.607	.227	.684	.235	.776	.221
AC EC	-.216	.722	-.717	.342	-.884	.284
SIZE			.421	.316	-.081	.898
LEVERAGE			2.632	.057*	3.389	.034**
PERFORMANCE			-1.912	.000***	-2.689	.000***
CONSUMER PRODUCT					1.085	.329
HOTELS					.074	.974
INDUSTRIAL PRODUCT					-.534	.589
INFRASTRUCTURE PROJECT COMPANY					.725	.728
PLANTATION					1.773	.433
PROPERTY					.943	.347
TRADING AND SERVICES					.942	.307
TECHNOLOGY					2.011	.156
YEAR 2006					-.399	.737
YEAR 2007					-.566	.653
YEAR 2008					.231	.858
YEAR 2009					-1.152	.374
YEAR 2010					-.273	.855
Nagelkerke R Square	.080		.380		.453	
Hosmer and Lemeshow Test	.172		.554		.488	

Note: *, **and *** represents statistical significance at 0.01, 0.05 and 0.1 levels, respectively

Surprisingly the result of the audit committee independent positively related to the corporate fraud. The result is significant at 0.05 level as shown in the table above. Thus, hypothesis 1 is rejected. This study is opposite to the study by Beasly (1996) and Uzun et al. (2004) that their studies find a negative relationship between audit committee independent and corporate fraud. The audit committee expertise and corporate fraud posit a negative relationship that is marginally significant (0.10 significant level). However, the other independent variable tested in this study has found no relationship with the corporate fraud. The control variable of firm size has shown an insignificant result with corporate fraud. On the other hand, leverage shows a significant result in relation to corporate fraud at 0.05 level and performance document negative relationship with corporate fraud at

0.01 level. The result for the regression model has been controls by various factors. The result for audit committee independent and audit committee expertise is robust.

6. Conclusion

Corporate fraud is a serious problem that arises in the organization especially on 21st century. This matter gives an impact on the financial condition of the companies. The company that involved in fraud would affect the stockholders as well as the potential investors' to lose confidence, gain a bad perception from the business communities and decrease in firm value (Kamarudin et al., 2012). The effectiveness of the audit committee in Malaysia in order to curb financial statement fraud still is questionable because of the increase in the financial statement fraud cases. Therefore, the aim of this study is to examine the audit committee attributes and propensity of fraudulent financial reporting. Surprisingly, the finding of this study indicates that there is a positive relationship between audit committee independent and corporate fraud. It is consistent with the study by Abdullah et al. (2010) stated that the presence of independent audit committee is significant caused the firm misstated their financial position. It shows that the higher independent directors on the committee, the higher the fraud incurred in the companies. This may be due to the independent director is consisting of outside member that have a little knowledge of the company business. It is difficult for them to oversee the company and some of the director is holding more than one directorship. It is opposite to most of the study where they found a negative relationship between audit committee independent and corporate fraud such as the study by Beasly (1996) and Uzun et al. (2004). Expertise in audit committee indicates a negative result in association to corporate fraud. This indicates that the presence of financially literate member may enhance the company do not involve in fraud. It is consistent with the study by Kang et al. (2011) and Huang and Thiruvadi (2010). However, the result for other independent variables indicates that there is no significant relationship between the variables and corporate fraud. The control variables show that only firm size is insignificant with the corporate fraud. This may be due to the size of the firm for fraud, and non-fraud firm is pair according to the total assets in this study. In addition, leverage indicates a positive relationship with the corporate fraud. The company with high leverage encourages the company to commit fraud. Further, performance is negatively significant with corporate fraud. It shows that the performance of the firm is good thus the corporate fraud is low. This study provides up to date information regarding audit committee attributes and corporate fraud. Additionally, this study document evidence for the literature between audit committee characteristics and corporate fraud. Further, this study gives a viewpoint to MCCG about the importance of the audit committee financial expertise and the role of independent audit committee in the company. There are several limitations applies to this study. The small sample size used in this study may not provide strong relation using a statistical method to generate a good result. Besides that, this study only focus on

Malaysia companies from the year 2006 to 2010 which not take into account the current year company that commit in fraud. Thus, the result cannot be generalised to all of the listed companies in Malaysia. Future research needed to address several issues. This study suggest that the other factors of the audit committee attributes to take into consideration such as directorship hold by the committee, remuneration factors, and performance of the committee.

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