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Independence and Financial Knowledge on Audit Committee with Non-compliance of Financial Disclosure: A Study of Listed Companies Issued with Public Reprimand in Malaysia

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Abstract

This paper aims to describe the public reprimand issued by Bursa Malaysia to PLCs pertaining to financial related information. It was found that public reprimand were sanctioned for non-compliance of the requirements related to continuing disclosure with amounted to 145 breaches for year 2009 until 2013. It was also discovered that most of the companies sanctioned for public reprimand had complied with the minimum requirements for the independence and financial knowledge on audit committee. This study is a cross-sectional content analysis and consists of firms that had been reprimanded by Bursa Malaysia for non-compliance with the listing requirements.

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1. Introduction

The board of directors should always uphold the legitimate interest of the shareholders and provide stakeholders with a balanced and understandable assessment of the organisation's position and prospects. The board of directors must ensure that the organisation's reports and accounts contain clear narration; that supported by figures. This information is vital for investors, creditors, customers and suppliers to make relevant decisions. An audit committee has been given the task to assist the board of directors for a more effective oversight role, particularly in financial

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reporting integrity. A more effective and efficient governance mechanism is urgently required as more companies are involved in the major corporate failures (e.g. Adelphia, Enron, Tyco and Worldcom). The regulators have regularly revised the governance mechanism and considered an audit committee as guardian of shareholders' interest. Hence, they should be able to critically monitor the financial reporting system.

Many researchers focus on audit committee and financial reporting (Abbott, Parker, & Peters, 2002; Lin, Li, & Yang, 2006; Siti Rochmah Ika, 2012). These studies mainly concentrate on audit committee, overall corporate governance system and earnings management, abnormal earnings and restatement. Other studies concentrate on the effects of monitoring mechanisms and earnings management (Abdullah, Yusof, & Nor, 2010; Rahman & Ali, 2006; and Saleh & Iskandar, 2007) and only few studies use information that is related to specific monitoring mechanism towards and incidence of failure in the financial reporting process (Lakshan & Wijekoon, 2012). The literature is therefore comparatively lacking in studies on audit committee independent and financial knowledge which may significantly influence the quality of financial report and continuous disclosure.

A financial report is important as it is used by the investors to make investment decisions. It describes the company's future performance and financial health of the companies. Therefore, the characteristics of inefficient audit committee may be reflected in firms that provide unreliable financial disclosure and fail to report the firm's current position in a timely manner. Information on the characteristics of an audit committee is useful for investors, regulators and other users of financial statements to understand and detect any criteria associated with good financial report, especially, in a competitive corporate environment. The awareness of investors would encourage the companies to voluntarily establish an effective control mechanism in order to ensure good financial reporting system. This relationship is assumed to be established due to the fact that one of the main roles of an audit committee is to oversee the financial activities of a company and to stimulate effective communication between the board of directors and the external auditors (Vanasco, 1994).

In addition, effective role of audit committee should further be encouraged, where member should always have independent in mind and exercise their skill and knowledge in demanded and required manner especially in terms of probing difficult financial issues. An audit committee with appropriate level of independent and financial knowledge should be able to increase the quality of financial reporting.

The present studies undertake to examine the audit committee characteristics specifically, independent and financial knowledge and the firms which fail to comply with continuous disclosure requirements. This information may address the issue of misstatement as a result of failure to provide true, accurate and reliable financial reports.

2. Rules and Regulations on Financial Disclosure

The financial report provides information relates to the company performance and its financial health. The financial information should reach the investors in a timely manner to ensure its relevancy with current situation. Financial information may become stale and less relevant to its potential investor and creditors after a few months. Therefore, the investors and other stakeholders need to receive the information while it is still relevant for investment analysis and decision making. For public listed companies, periodic disclosures are set out under Chapter 9 Part K of Bursa Malaysia Listing Requirements. The regulations require the public listed company to disclose its financial information on a quarterly and annual basis.

One of the main tasks of an audit committee is to ensure the reliability of financial reporting and oversee a firm's performance. Bursa Malaysia sets out the functions for audit committees in order to carry out its responsibilities as stipulated under Main Market Listing Requirements paragraph 15.12. Among the functions which are related to financial reporting is that an audit committee must review the quarterly results and year-end financial results. The review focuses on the changes in implementation of major accounting policy, any significant and unusual events and compliance with accounting standards and other legal requirements.

With effect from 1 January 2009, Bursa Malaysia Listing Requirements has included that all members of audit committee must be non-executive directors with the majority of independent directors. Furthermore, it also required that all members of the audit committee to be financially literate and at least one should be a member of an accounting association or professional body. It further recommend for a company to increase in the frequency of meetings between the audit committee and the external auditor without the presence of executive board members. The purpose is to provide more independent views and any decision can be effectively deliberated. These are among the amendments

that have been done in order to strengthen the board of directors and the audit committee, and to ensure the effectiveness of their roles and responsibilities (MCCG 2012).

2.1. Enforcement action by Bursa Malaysia

Bursa Malaysia will take appropriate enforcement action, if any of the listed companies fail to comply with the Bursa Malaysia Listing Requirements and Bursa Rules. Bursa Malaysia will give a certain period of time for the company to reply on non-compliance. The types of sanctions include, (i) reprimand (private and public) (ii) fines, (iii) remedial actions, (iv) suspension and (v) de-listing or striking off. Bursa Malaysia will appoint the independent external parties or industry expert to act as the relevant regulatory committee of Bursa Malaysia. This committee will be given the authority to provide the enforcement decisions. The defaulting parties will be given the opportunity to provide explanation to this committee before final decision on appropriate sanction has been made.

3. Literature Review

In order to comply with this requirement, it would surely require a good oversight role of internal governance structure because the firms do not only need to issue timely financial reports but also accurate, credible and reliable ones. This could be important criteria for an early detection of any possibilities of misstatements or fraud. The improvement in quality of governance system is also crucial to ensure that the firms could continuously maintain its oversight functions. According to Malaysian Code on Corporate Governance (2012), the basic function of the audit committee is to satisfy itself that the company maintains internal control systems which should reasonably provide an assurance on the reliability of financial information used within the business and also for publication. This indicates the importance of a company to establish an effective audit committee to provide an oversight mechanism in financial reporting.

3.1. Audit committee independent

The independence of an audit committee has been mentioned in many previous studies. It is the key characteristic of an audit committee which is normally associated with audit committee effectiveness. Abbott & Park, (2000) found that the independence of an audit committee is negatively associated to misstatements. However, they further explained that the size of the committee and financial expertise of the audit committee members provide significant negative relationship. Owens-Jackson, Robinson, & Shelton, (2009), also found that audit committee independence and number of audit committee meetings are negatively related to the likelihood of fraudulent financial reporting.

In addition, various studies related to independence on audit committee provide empirical evidence that independence can be important attributes for financial reporting (Dimitropoulos & Asteriou, 2010; Koh, Kelley, & Tong, 2007; Siagian & Tresnaningsih, 2011).

3.1. Audit committee financial knowledge

Audit committee financial knowledge has been given considerable attention in the prior research. This characteristic is also linked to the audit committee effectiveness. There are several empirical evidences which support the argument that a financially knowledgeable audit committee will indeed benefit the company as it would lower the probability of earnings restatement (Abbott et al., 2002). Mustafa & Youssef, (2010) conduct a study to test on the interaction between AC members' financial expertise and their independence. They found that the independent director who also a financial expert can effectively reduce the occurrence of misappropriation of assets in publicly held companies. A study found that accounting expertise gain from public accounting experience associated with timelier financial reporting (Abernathy, Beyer, Masli, & Stefaniak, 2014). They suggest that AC accounting expertise contributes to AC effectiveness by improving the timeliness of financial information (Abernathy et al., 2014). However, they also found that accounting expertise gained from CFO experience is not. Another study focus on audit committee oversight functions, where the study suggest that firms with an accounting expert on the audit committee

can reduce the likelihood of managers to engage in expectations management. These studies suggest on the quality of financial expertise possess by an audit committee member can influence the effectiveness of audit committee, in ensuring the quality of financial reporting and its oversight function.

4. Methodology

This research is a cross-sectional content analysis type of research, which involve data collected at a defined time. For this purpose, annual reports of public listed companies in Bursa Malaysia and Bursa Malaysia website i.e., media release section for public enforcement on company or advisor, for year 2009 to 2013 were closely analysed in accordance with the objectives of the research.

This research does not involve any random selection; therefore, it adopts a non-probability sampling. As far as the non-probability sampling is concerned, purposive sampling is the most appropriate sampling technique for this research. Hence, for this research, only those public listed companies that have breached the Bursa Malaysia Listing Requirements for year 2009 to 2013 were selected for further examination. Sample size of the research derives from the numbers of companies that have breached the Bursa Malaysia Listing Requirements related to financial reporting and disclosure for year 2009 to 2013. Out of the total number of public listed companies in Bursa Malaysia for these years, 87 were identified have been committed such breaches. In order to achieve objective one (1) and two (2) of this research, all these 87 companies are treated as the sample. However, in achieving objective three (3), two (2) criterias need to be fulfilled before the final number of companies to be chosen as the sample. In other words, this criteria include; (1) listed companies that has not been delisted, suspended or/and liquidated until the year 2013; and (2) companies that have breached any paragraph in chapter 9 (continuing disclosure) of listing requirement. In this regard, 45 listed companies as stated in table 5.1 below were qualified under the first criteria. Hence, this reason, 40 companies deemed qualified and fit for further analysis.

The sample of this study consists of firms that had been reprimanded by Bursa Malaysia for non-compliance with the listing requirements. In this regard, firms that are listed in the Main Market of Bursa Malaysia that have been sanctioned with public reprimand for year 2009 to 2013 were selected for analysis. Accordingly, Table 1 below depicts these criteria according to years.

Table 1: Number of Firms with Public Reprimand for Year 2009 -2013

Year	Listed	Delisted	Others	Total
2009	8	9	1	18
2010	9	13	2	24
2011	12	6	2	20
2012	5	4	1	10
2013	11	3	1	15
Total	45	35	7	87

In doing so, a content analysis was used as a method for data collection. Data derived from annual report and Bursa Malaysia website was grouped and quantified accordingly using software called the Statistical Package for the Social Sciences (SPSS). Descriptive statistics and cross tabulations were used to analyse the findings for the research. The findings of the research were then analysed using frequency and demonstrated in series of tables. Since this research comprehends the periodic financial disclosure of public listed companies in Malaysia, therefore the unit of analysis for this research is Malaysian public listed companies.

5. Results and discussion

Overall, it is evident that 87 firms had been sanctioned with public reprimand during the five years of business operation. The number of public reprimand issued to the respective firms is greater in year 2010. However, the two years in a row after that the number of public reprimand issued has reduced gradually i.e., 20 public reprimand issued in year 2011 reduce to 10 public reprimand issued in year 2012. Although in year 2013 have seen a slight increase in the number of public reprimand issued. i.e., 15 public reprimands, but this number is still low as compared to public reprimand issued in year 2010. The researchers conclude that the reduction of public reprimand issued is perhaps due

to effectiveness of enforcement action taken against the companies that had breach Bursa Malaysia Listing Requirements.

It was found that there are seven (7) paragraphs/chapters in which breaches had occurred (see Table 2). These 7 chapters were derived after one-by-one content analysis made by the researchers using information available in the Bursa Malaysia website for year 2009 – 2013. Out of these 7 chapters, chapter 9 i.e., continuing disclosure has reported the highest number of breaches made by the public listed companies during the five years of analysis. The firms with public reprimand were sanctioned for failure to comply with the requirements related to continuing disclosure (Chapter 9), amounted to 145 breaches for year 2009 until 2013. Out of this number, most firms had breached the requirement pertaining to content of press of other public announcement (54 breaches). Overall, the amount of breaches of this chapter 9 is the highest as compared to other chapters in the listing requirement. From to the analysis, the researchers found that the companies with public reprimand mainly companies had been reported with financial difficulties and eventually had led them to breach the continuous financial disclosure.

Table 2: Types of Public Reprimand According to Chapters in Bursa Malaysia Listing Requirement

Chapter	Topic
Chapter 2	General 2.13: Form of Information, 2.18: Contents of statement, information or document, 2.19: Indemnity
Chapter 8	Continuing Listing Obligations 8.22: Material variations, 8.23: Provision of financial assistance, 8.28: Notice of maturity
Chapter 9	Continuing Disclosure 9.03: Disclosure of material information, 9.04: Examples of events which may require immediate disclosure, 9.16: Content of press or other public announcement, 9.19: Immediate announcements to the Exchange, 9.22: Quarterly report, 9.23: Issue of annual audited financial statements and annual report, 9.24: Annual audited financial statements in consolidated form, 9.26: Issuance of annual report in electronic format, 9.28: Suspension or de-listing for failure to comply, 9.47: Immediate announcements to the Exchange
Chapter 10	Transactions 10.04: Valuation, 10.06: Requirements for transactions with percentage ratio of 5% or more, 10.08: Related party transactions
Chapter 14	Dealings in Listed Securities 14.08: Procedure for dealings during closed periods, 14.09: Procedure for dealings outside closed periods
Chapter 15	Corporate Governance 15.09: Composition of the audit committee, 15.27: Internal audit
Chapter 16	Suspension, de-listing and enforcement 16.11: De-listing the Exchange, 16.13: Breach by directors

The study found that the number of independent audit committee members ranging from 2 to 7 directors with a mean of 2.54 directors. According to the Listing Requirements of Bursa Malaysia, one of the audit committee members must have a professional accounting qualification. However, the findings reveal that there are audit committees with none of its members having a professional accounting qualification. This indicates that these companies do not comply

with the listing requirements. Non-compliance with the composition of audit committee requirements may provide explanation on issuance of public reprimand due to the lack of financial expertise and independent judgment. However, findings also show that majority of the companies comply with the minimum requirement of composition of audit committee independent and financial knowledge reported to have the highest amount of total reported breaches.

Table 3: Cross Tabulation of Types of Breaches with Independence and Financial Knowledge

Types of Breach	Number of Directors						Total	%
	ACIND			ACFKNOW				
	2	3	4	1	2	3		
LATE	2	2	0	3	0	1	4	10
INACC	6	17	3	22	4	0	26	65
MAT	2	5	1	7	1	0	8	20
INACC_MAT	0	1	0	1	0	0	1	2.5
All	0	1	0	1	0	0	1	2.5
Total	10	26	4	34	4	1		

Variable definitions:

LATE = the occurrence of late submission of quarterly report, audited account and annual report (9.22&9.23); INACC = the occurrence of inaccurate announcements on financial related matters (9.16); MAT = the occurrence of firms fail to make immediate announcements of material information (9.03 & 9.04); INACC_MAT = the occurrence of inaccurate announcements and fail to make immediate announcements; ALL = the occurrence of all types of breach; ACIND = Number of independent directors on audit committee; ACKNOW = Number of audit committee members with professional accounting qualifications;

According to Table 3, the highest type of breach is the occurrence of inaccurate announcements on financial related matters which amounted to 26 reported breaches as compared to other types of breaches. Most companies reported to provide inaccurate announcements on financial matters, do comply with the requirements on the composition of audit committee. These companies reported to have 3 independent non-executive members and at least one member with financial knowledge.

The total amount of reported breaches for companies with 2 independent non-executive members is 10 reported breaches. These companies fail to comply with the minimum requirements for composition of audit committee. However, companies with 3 independent non-executive members are reported to have higher total amount of reported breaches that is 26 reported breaches. These companies are complying with the requirements for composition of audit committee, have reported the highest amount as compared to the other companies. In addition, the total reported breaches for companies with at least one member with financial knowledge is 34 reported breaches and this is also the highest amount as compared to other companies that reported to have two or three members with financial knowledge.

Therefore, in these cases the compliance on composition of audit committee independent and financial knowledge does not guarantee the companies for not being reprimanded. Most of these companies successfully comply with the requirements on the establishment of audit committee, however, the functions of the audit committee is evidently less effective.

6. Conclusion

The audit committee with appropriate level of independent and financial knowledge should be able to prevent from any non-compliance of continuous financial disclosure. Public listed companies that comply with the minimum requirement should be able to prevent themselves from being reprimand. The regulators are on the opinion that if the

companies are able to comply with the requirements of level of independent and financial knowledge, this can protect the interest of the investor. However, the claim may not be materialized in companies being reprimanded by the Bursa Malaysia. In this study particularly, these companies had complied with the minimum requirements on the level of independent and financial knowledge of audit committee, but still being reprimanded for failure related to continuous financial disclosure. This finding is consistent with the previous research which found that companies with a good corporate governance practices still had fraudulent financial reporting (Owens-Jackson et al., 2009).

The effectiveness of enforcement by regulatory bodies and active role of shareholders raising concern on companies affairs, helped the number of public reprimanded issued against the company to decline gradually. However, many factors should be considered by the regulators before any existing regulation can be revised (Lander & Auger, 2008). For example, a family owned company need to be put special attention regarding the regulations on the appointment of independent directors (Leung, Richardson, & Jaggi, 2014). Owens-Jackson et al., (2009) further suggest that the regulators should pay particular attention for large companies with low managerial ownership structure. This is due to the pressure put on the managers to meet the investors expectation (Owens-Jackson et al., 2009).

There are many other possible areas that can be explored in future research relating to the effectiveness and functions of an audit committee. As such, it would be interesting, if characteristics of the audit committees addressed using a qualitative approach methodology. The sample of the study may also be compared to a sample of firms which have been recognised to have a good governance system.

Apart from that, the study can be conducted by considering other relevant theories such as the Theory of Action Reasoning that relates to human behaviour concerning individual attitudes, belief systems; ethics; intended actions; and perceptions. This could provide an in depth explanation on the strengths and effectiveness of unique audit committees rather than just looking into the number of meetings, number of audit committee members and other regulatory set up, in which it may only be on paper compliance and have no substance in its implementation to achieve the required objectives.

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